TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TER[redacted] 1962

No. [redacted] 78

CHESTER A. PEARLMAN, TRUSTEE,
PETITIONER,

vs.

RELIANCE INSURANCE COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 5, 1962

CERTIORARI GRANTED APRIL 16, 1962

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1961

No. 771

CHESTER A. PEARLMAN, TRUSTEE,
PETITIONER,

vs.

RELIANCE INSURANCE COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

INDEX

RECORD PRESS, PRINTERS, NEW YORK, N. Y., JUNE 29, 1962

[fol. A] [File endorsement omitted]

[fol. 1]

Appendix of Appellant—Filed November 16, 1961

Proceeding in Bankruptcy

IN UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NEW YORK

In the Matter

of

Dutcher Construction Corporation, Bankrupt.

In Bankruptcy No. 41068

Attorneys:

For Reliance Insurance Company—Vaughan, Brown, Kelly, Turner & Symons, 440 M & T Building, Buffalo 2, New York.

For Chester A. Pearlman, Trustee in Bankruptcy of Dutcher Construction Corporation, Bankrupt—Raymond T. Miles, 942 Ellicott Square Building, Buffalo 3, New York.

Show Cause Order Dated September 21, 1959

Upon the petition of Reliance Insurance Company (formerly Fire Association of Philadelphia), verified September 4, 1959,

Let the Trustee, creditors and others interested in the estate of the named bankrupt show cause before the [fol. 2] Bankruptcy Court herein, at Room 416 United States Court House, Niagara Square, in the City of Buffalo, New York, on the 14 day of October, 1959, at 10:00 o'clock in the forenoon of that day, why an order should

not be made directing the Trustee herein to pay over forthwith to said petitioner the sum of Eighty-Seven Thousand Seven Hundred Thirty-Seven Dollars and Thirty-Five Cents ($87,737.35) being the proceeds of a payment by the U. S. Engineers, received and now held by the Trustee herein, covering work, labor and services rendered and performed by the bankrupt herein on the St. Lawrence Seaway Prime Contract, known as Contract No. DA-30-023-eng-339, and on which the petitioner was surety for said bankrupt, and why said petitioner should not have such other, further and different relief as to this Court may seem just and proper.

Dated: Buffalo, New York, September 21, 1959.

James R. Privitera, Referee in Bankruptcy.

In United States District Court

Petition of Reliance Insurance Company

The petition of Reliance Insurance Company (formerly Fire Association of Philadelphia) respectfully shows:

That it is an insurance corporation duly organized and existing under and by virtue of the laws of the Commonwealth of Pennsylvania, with its principal office and place of business located at 401 Walnut Street, Philadelphia, [fol. 3] Pennsylvania. That the name of the corporation, prior to January 1, 1958, was Fire Association of Philadelphia, and is hereinafter referred to as the "Surety".

That heretofore and on or about November 19, 1951, the Dutcher Construction Corporation, the bankrupt herein, made, executed and delivered to the Surety its certain General Indemnity Agreement, a copy of which is annexed hereto, marked Exhibit "A", and made a part hereof.

That on or shortly prior to April 11, 1955, the bankrupt applied to the Surety for payment and performance bonds in connection with a prime contract then about to be entered into between the bankrupt and the United States of America, Corps of Engineers, relating to the St. Lawrence Seaway, and known as Contract No. DA-30-023-eng-339.

That in reliance upon Exhibit "A", the Surety, as surety for said bankrupt and not otherwise, on or about April 11, 1955, made, executed and delivered the payment and performance bonds herein referred to, a copy of which Performance Bond is attached hereto, marked Exhibit "B", and a copy of which Payment Bond is attached hereto, marked Exhibit "C", and both of which are made a part hereof.

That upon the furnishing to and filing with the Corps of Engineers of said payment and performance bonds, the bankrupt was duly awarded said prime contract and entered upon the performance thereof.

That thereafter, and on or about April 11, 1956, the United States of America, with the consent of said bankrupt, terminated the aforesaid prime contract of April [fol. 4] 11, 1955, and that on or about August 30, 1956, the bankrupt was adjudicated a bankrupt by this Court.

That the bankrupt, during its prosecution of said contract and prior to its determination on April 11, 1956, as aforesaid, incurred various bills for labor, materials and services in the performance of its said prime contract, which were covered by the Surety's payment bond, and that prior to April 11, 1956, said bankrupt was in default in the payment of substantial portions of said bills and obligations covered by the Surety's said payment bond.

That during the spring and summer of 1956, various demands were made upon the Surety by the several creditors of the bankrupt who were covered by said payment bond, and that pursuant to said demands and in discharge of its obligations and duties under said payment bond, the Surety paid to said beneficiaries under said payment bond the sum of Three Hundred and Twenty-Six Thousand Two Hundred Forty-Eight Dollars and Forty-Two Cents ($326,248.42) and, in addition thereto, incurred and paid expenses in connection therewith, in the sum of Twenty Thousand Seven Hundred Fifty-Four Dollars and Thirty-Four Cents ($20,754.34), making a total of Three Hundred Forty-Seven Thousand Two Dollars and Seventy-Six Cents ($347,002.76).

That in addition to the foregoing, the Surety paid, in response to a judgment secured against it in the United States District Court for the Northern District of New York, the sum of Eighteen Thousand Eight Hundred Seventy-Eight Dollars and Forty-Seven Cents ($18,878.47) for tires furnished to the bankrupt for use on said prime contract, by which judgment said Court held the Surety [fol. 5] liable therefor, and the further sum of Four Thousand Forty-Five Dollars and Ninety-Two Cents ($4,045.92) to Credle Equipment, for which the Surety was liable under said payment bond, making a total of claim payments of Three Hundred Forty-Nine Thousand One Hundred Seventy-Two Dollars and Eighty-One Cents ($349,172.81).

That the bankrupt, prior to the termination of its prime contract on April 11, 1956, had earned in performance thereof sums in excess of Eighty-Seven Thousand Seven Hundred Thirty-Seven Dollars and Thirty-Five Cents ($87,737.35); that out of the sums so earned by the bankrupt the United States of America, acting through the Corps of Engineers, paid, satisfied and discharged all its claims and demands relating to all work performed by the bankrupt, and that during the summer of 1959 said United States of America paid to the Trustee in Bankruptcy of the bankrupt the sum of Eighty-Seven Thousand Seven Hundred Thirty-Seven Dollars and Thirty-Five Cents ($87,737.35) for work performed by the bankrupt on said prime contract prior to April 11, 1956, which said sum the Trustee in Bankruptcy of the bankrupt now holds.

That subsequent to the bankruptcy of the bankrupt, and within the time required by law, and on or about March 22, 1957, the Surety duly filed its claim against the bankrupt herein with the Referee in Bankruptcy of this Court, to which reference is hereby made, and which is incorporated herein by reference as though fully set forth herein.

That in and by said claim the Surety asserted a first priority: 1) in the aforesaid sum of Three Hundred Forty-Seven Thousand Two Dollars and Seventy-Six Cents [fol. 6] ($347,002.76), together with 2) such additional sums as it might pay or be compelled to pay in the discharge

of its obligations under the aforesaid payment bond, which amount was, at the time of filing said claim, contingent and unliquidated, but which has now become liquidated and fixed, at least to the extent of the payment of said judgment, in the aforesaid sum of Eighteen Thousand Eight Hundred Seventy-Eight Dollars and Forty-Seven Cents ($18,878.47), and the further sum of Four Thousand Forty-Five Dollars and Ninety-Two Cents ($4,045.92), as aforesaid.

That in and by said proof of claim the Surety further asserted:

"That as to the aforementioned debt, both liquidated, unliquidated and contingent, this creditor claims and asserts it is entitled to priority in the payment thereof, including by way of liens, subrogation and assignment, from the following sources:

1. Unpaid contract balances, including all estimates, retainages, extras, claims for changed conditions, damages and final estimates unpaid under the bankrupt's aforesaid prime contract with the United States of America, Corps of Engineers, as aforesaid, together with any and all other recoveries, if any, made by the Trustee in Bankruptcy herein on behalf of said bankrupt, growing out of or pertaining in any manner to the aforesaid prime contract with the United States of America, Corps of Engineers."

That by virtue of the foregoing, the Surety is the owner of said sum of Eighty-Seven Thousand Seven Hundred [fol. 7] Thirty-Seven Dollars and Thirty-Five Cents ($87,737.35), free and clear of the claims of the Trustee in Bankruptcy or any other person, firm or corporation, and is entitled to have said sum paid to it forthwith.

Wherefore, your petitioner, the Surety herein, respectfully asks that an order be granted herein requiring the Trustee in Bankruptcy herein, and all such other persons as this Court shall determine are entitled to notice of this application, to show cause why an order should not be

made directing the Trustee in Bankruptcy herein to pay over forthwith to the Surety the aforesaid sum of Eighty-Seven Thousand Seven Hundred Thirty-Seven Dollars and Thirty-Five Cents ($87,737.35), and why your petitioner, the Surety herein, should not have such other, further and different relief as to this Court may seem just and proper.

Dated: September 4th, 1959.

Reliance Insurance Company, By Addison Roberts, Its Vice President.

Duly sworn to by Addison Roberts, jurat omitted in printing.

[fol. 8]

EXHIBIT "A" TO PETITION

FIRE ASSOCIATION OF PHILADELPHIA

GENERAL INDEMNITY AGREEMENT

WHEREAS, the undersigned, hereinafter called Indemnitors, have requested, and may hereafter request, the FIRE ASSOCIATION OF PHILADELPHIA, a corporation duly incorporated under the laws of the State of Pennsylvania, hereinafter called the Company to execute and procure the execution of various and sundry bonds, undertakings and recognizances (all of which will hereafter be included within the term bond) as have been, and such as may hereafter be, applied for, whether by formal application or orally or by letter or otherwise, directly or through any agent, attorney or other representative, by the Indemnitors or any one or more of them; and the Company upon the express condition that this instrument be executed, and in consideration thereof, has executed or procured the execution [fol. 9] of, and may from time to time hereafter execute or procure the execution of, such bond or bonds, it being understood that all such bonds shall be covered hereunder, whether or not it is specifically so stated or agreed at the time the application is made.

NOW, THEREFORE, in consideration of the premises and the sum of One Dollar ($1.00) this day paid by the Company to each of the Indemnitors receipt of which is hereby acknowledged, the Indemnitors, and each of them, for themselves, their and each of their heirs, executors, administrators, successors and assigns, jointly and severally, do hereby covenant and agree:

1. To pay or cause to be paid to the Company, as a consideration for becoming surety on such bond or bonds, an annual premium or charge upon each bond, to be computed at such rate as may be agreed upon by the Indemnitor and the Company. Such premium shall be paid in advance on the date of execution of any such bond and shall not be subject to any reduction in amount, and all subsequent premiums shall be paid annually thereafter in advance on the corresponding date of succeeding years, as long as the Company shall remain liable, and until it shall have been fully discharged and released from any and all liability upon such bond or bonds and all matters in any wise incident thereto, and until there shall have been furnished to the Company, at its Home Office in the City of Philadelphia, due and satisfactory proof, by evidence legally competent, of such discharge and release.

2. To indemnify the Company from and against any and all liability, loss, costs, damages, attorneys' fees and [fol. 10] expenses of whatever kind or nature which the Company may sustain or incur by reason or in consequence of executing any such bond or bonds as surety or co-surety or procuring, upon its full indemnity, the execution thereof as aforesaid, and which it may sustain or incur in making any investigation on account of any such bond or bonds, in defending or prosecuting any action, suit or other proceeding which may be brought in connection therewith, in obtaining or attempting to obtain a release from liability under any such bond or bonds, and, if any such bond be a bail bond in locating, extraditing and surrendering the person bailed; and to indemnify the Company to the full amount of liability, loss, costs, damages, attorneys' fees and expenses as aforesaid regardless of any reinsurance that may be carried on such bond or bonds, it being the

object and intent hereof that this instrument shall protect, in the name of the Company, any and all surety or reinsuring companies that may assume reinsurance upon any such bond or bonds; and in like manner, to indemnify such other surety or sureties as the Company has procured or may procure, otherwise than upon its full indemnity, to execute or to join with it in executing any such bond or bonds, it being agreed that this instrument shall inure to the benefit of any such surety or sureties, so as to give it or them a right of action hereunder.

3. That any property of any kind which may have been, or may hereafter be, pledged as collateral security on any one or more of such bonds may, at the option of the Company, be retained as collateral security on any or all bonds coming within the scope of this agreement, whether theretofore or thereafter executed and whether executed by the [fol. 11] Company or any other surety or sureties, and for the full and complete performance in all respects of the covenants of the Indemnitors under this agreement; and in case of any breach of the covenants of the Indemnitors, or in case the Company should deem it advisable to raise money for the purpose of meeting any actual or prospective claim or demand under any such bond or bonds or to pay any expenses incurred or to be incurred in connection therewith, or in case the Company should be of opinion that said property is likely to so decline in market value that the security to the Company will be inadequate, the Company shall have full power and authority, without notice to the Indemnitors or any of them, to sell, assign and deliver said collateral, or any part thereof, at public or private sale, at the option of the Company, its successors or assigns, with the right to be the purchaser itself at any such public sale, and to use all of the proceeds, or such part thereof as may be necessary, in order to protect itself and any other surety or sureties executing any such bond or bonds against loss, costs, damages, attorneys' fees and expenses as aforesaid; and after deducting all legal and other costs and expenses of such sale, and all such loss, costs, damages, attorneys' fees and expenses as aforesaid, and all premiums due the Company or any such surety or sureties for any such bond or bonds, shall return the remainder

of such collateral or the proceeds of sale, if any, to the person or persons legally authorized to receive the same; provided the Company shall not be responsible for any loss resulting to the said property from any cause other than the act or neglect of its officers or employees.

4. That the Company, surety or sureties executing any such bond or bonds shall have the right, and such Com-[fol. 12] pany, surety or sureties are hereby authorized, but not required—

a. If any such bond or bonds be given in connection with a contract, to consent to any extensions, modifications, changes or alterations of, or additions to, the contract and the plans and specifications therein referred to, and from time to time make advances or loans to the principal for the purposes of the contract, without the necessity of seeing to the application thereof, it being hereby agreed that the amount of such advances or loans shall be conclusively presumed to be a loss hereunder; and to take possession of the work under such contract in event of any abandonment or forfeiture of such contract or of any breach thereof or of such bond or bonds, and, at the expense of the indemnitors, to complete, or to contract for the completion of, the same, or to consent to the re-letting or completion thereof by the owner;

b. If any such bond or bonds be filed in, or given in connection with a suit, action or proceeding in any court, to recognize any attorney or attorneys appearing of record in such suit, action or proceeding for any party thereto at the date of the execution of said bond or bonds, as the authorized representative of said party or parties with full and ample authority to act for such party or parties throughout such suit, action or proceeding and throughout any and all appeals therein, until the Company, surety or sureties shall have been fully discharged from liability under said bond or bonds;

[fol. 13] c. From time to time to increase or decrease the penalty or penalties of said bond or bonds, to

change the obligee or obligees therein and to execute, from time to time, any continuances, enlargements, modifications and renewals of any such bond or bonds, or any substitutes therefor, with the same or different conditions, provisions and obligees, and with the same or larger or smaller penalties, it being hereby agreed that this instrument shall, in all its terms, apply to and cover any and all such new or changed bonds or renewals.

d. To take such steps as it or they may deem necessary or proper to obtain release from liability under any such bond or bonds, including the right, if said bond be a bail bond, to surrender the person bailed at any time either before or after default;

e. To adjust, settle or compromise any claim, demand, suit or judgment upon any such bond or bonds, unless the Indemnitors shall request such Company, surety or sureties to litigate such claim or demand, or to defend such suit, or to appeal from such judgment, and shall, simultaneously with such request, deposit with such Company, surety or sureties collateral satisfactory to it or them, sufficient to pay any judgment or judgments rendered, or that may be rendered, with interest, costs, expenses and attorneys' fees.

5. If any such bond be given in connection with a contract, to assign, transfer and set over, and the Indemnitors do hereby assign, transfer and set over, to the Company, surety or sureties executing said bond or bonds, such as- [fol. 14] signment to become effective as of the date of said bond or bonds, but only in the event of any such abandonment, forfeiture or breach as aforesaid—

a. All their right, title and interest in and to all machinery, plant, tools and materials which are now or may hereafter be upon the site of the work embraced in such contract, or elsewhere for the purposes thereof, including all materials purchased or ordered for said contract, whether such materials be completely manufactured or not;

b. All their right, title and interest in and to any and all subcontracts let or which may be let in connection with such contract;

c. Any and all percentages of the contract price retained on account of said contract, and any and all sums that may be due under said contract at the time of such abandonment, forfeiture or breach, or that thereafter may become due;

d. All their rights in, and growing in any manner out of, said contract or said bond or bonds.

6. That liability hereunder shall extend to and include the full amount of any and all money paid by the Company, surety or sureties executing any such bond or bonds in settlement or compromise of any claims, suits, and judgments thereunder in good faith under the belief that it or they were liable therefor, whether liable or not, as well as of any and all disbursements on account of costs, attorneys' fees and expenses as aforesaid, which may be made under the belief that such were necessary, whether necessary or not.

[fol. 15] 7. That in the event of payment, settlement or compromise of liability, loss, costs, damages, attorneys' fees, expenses, claims, demands, suits and judgments as aforesaid, in connection with any such bond or bonds, an itemized statement thereof, sworn to by an officer or officers of the Company, surety or sureties making such payment, settlement or compromise, or the voucher or vouchers, or other evidence of such payment, settlement or compromise, shall be *prima facie* evidence of the fact and extent of the liability of the Indemnitors in any and all claims or suits hereunder.

8. That in the event the Company, surety or sureties executing any such bond or bonds should deem it necessary or proper, in order to comply with the law or with the regulations of the Insurance Department of any State, to set aside as loss reserve an amount to cover any judgment that may have been rendered against the principal, with interest and costs, or to cover any unadjusted claim or claims under said bond or bonds, the Indemnitors will,

immediately upon demand and notwithstanding any further proceedings that may have been taken, or that may be contemplated, by the principal, and notwithstanding the pendency of any appeal, deposit with said Company, surety or sureties an amount of money sufficient to cover such judgment, with interest and costs, or such claim or claims, such sums to be held by said Company, surety or sureties as collateral security on said bond or bonds, with the right on the part of the Company, surety or sureties at any time to use such sum, or any part thereof, in the payment of such judgment or in the settlement of such claim or claims; and the said Indemnitors, in the event of their [fol. 16] failure to comply with such demand, hereby authorize and empower any attorney of any court of record in the United States, or any of its territories or possessions, to appear for them or any of them in any suit or suits by the Company, surety or sureties executing said bond or bonds and to confess judgment against them or any of them for any sum or sums of money up to the amount of said bond or bonds, with costs and interest and a reasonable attorneys' fee; such judgment, however, to be satisfied upon the payment of any and all such sums as may be found to be due by the Indemnitors to such Company, surety or sureties under the terms of this agreement. Demand upon the Indemnitors shall be sufficient if sent by registered mail to each Indemnitor at the address given by him or her to the Company or at his or her address last known to the Company, whether actually received or not.

9. That if the Company, surety or sureties executing any such bond or bonds shall bring suit, action or proceeding to enforce any of the covenants or agreements herein contained, the costs, charges and expenses, including attorneys' and counsel fees incurred by such Company, surety or sureties in prosecuting such suit, action or proceeding shall be included in any judgment or decree that may be rendered against the Indemnitors therein.

10. To waive and do hereby waive—

a. All right to claim any of their property, including homestead, as exempt from levy, execution or sale, or other legal process, under the laws of any State or States;

b. Any defense based upon the execution of this agreement subsequent to the date of any such bond or [fol. 17] bonds, the Indemnitors admitting and covenanting that the execution of any such bond or bonds by the Company, surety or sureties was in pursuance of the previous request of the Indemnitors;

c. Notice of any breach, or breaches of any such bond or bonds or of any contract or contracts in connection with which such bond or bonds may have been given, or any act or default that may give rise to claim hereunder;

d. Any right to ask or require the Company, surety or sureties executing any such bond or bonds to remove or join in any application for the removal of any proceeding from a State court to a Federal court;

e. Notice of the acceptance of this obligation and of execution of any such bond or bonds;

f. The execution of this instrument by the principal.

11. That nothing herein contained shall be considered or construed to waive, abridge or diminish any right or remedy which the Company, surety or sureties executing any such bond or bonds might have if this instrument were not executed.

12. That the liability of the Indemnitors hereunder shall not be affected by any alleged agreement or promise, written, oral or implied, for other indemnity, or for other security by collateral or otherwise; nor by the release of any indemnity or security that may have been taken by, or the return or exchange of any collateral that may have been deposited with the Company, surety or sureties exe-[fol. 18] cuting any such bond or bonds, the Indemnitors hereby consenting to any ~~such release,~~ return or exchange; and if any Indemnitor signing this agreement is not bound for any reason or is or shall become released, this obligation shall still be binding upon each and every other Indemnitor, and the liability of the Indemnitors hereunder shall continue so long as the liability of the Company, surety or sureties under such bond or bonds shall continue and

until satisfactory evidence of discharge or release of such liability shall have been furnished to the Company.

13. That separate suits may be brought hereunder as causes of action accrue, and suit may be brought against all of the Indemnitors or any one or more of them; and the bringing of suit or suits upon one or more causes of action, or against one or more of the Indemnitors, shall not prejudice or bar the bringing of subsequent suits against all of the Indemnitors, or any one or more of them on any other cause or causes of action, whether theretofore or thereafter accruing.

14. That the Company is not obligated to execute any such bond or bonds or procure the execution thereof either upon its full indemnity or otherwise; and any attempt on the part of the Company to secure co-suretyship or reinsurance on any such bond or bonds shall be as agent for the Indemnitors and such attempt shall not impose upon the Company any separate and independent liability whatsoever.

15. This agreement, being based upon a valuable consideration, is to be construed according to the rules applicable to the construction of obligations given by compensated sureties.

[fol. 19] IN TESTIMONY WHEREOF, the Indemnitors have hereunto set their hands and affixed their seals this 19 day of November 1951.

DUTCHER CONSTRUCTION CORPORATION (Seal)
P. O. Address Queenstown, Maryland

By RALPH E. DUTCHER (Seal)
Pres.
P. O. Address Queenstown, Maryland

Attest RUTH S. DUTCHER (Seal)
Sec. & Treas.
P. O. Address Queenstown, Maryland

Signed, sealed and delivered
in the presence of

JAMES F. MCCLOSKEY
as to both

The aforegoing General Indemnity Agreement was brought to be recorded on June 12, 1956 and recorded in Liber 2 I P #18, folio 154, a Bond Record Book for Queen Anne's County.

T. Sorden Pippin,
Clerk.

[fol. 20]

Exhibit "B" to Petition

PERFORMANCE BOND

(See Instructions on Reverse)

Standard Form 25
Revised November 1959
Prescribed by General
Services Administration
General Regulation No. 5

Date Bond Executed
11 April 1955
4/2/55

Principal
DUTCHER CONSTRUCTION CORPORATION, a Delaware Corporation, of Queenstown, Maryland

Surety
FIRE ASSOCIATION OF PHILADELPHIA, a Pennsylvania Corporation, of Philadelphia, Pennsylvania

Penal Sum of Bond *(express in words and figures)*
One Million Ninety-eight Thousand Nine Hundred Twenty-one and 50/100 ($1,098,921.50) Dollars

Contract No.
DA-30-023-eng-339

Date of Contract
4/11/55
11 April 1955

[fol. 21] KNOWN ALL MEN BY THESE PRESENTS. That we, the PRINCIPAL and SURETY above named, are held and firmly bound unto the United States of America, hereinafter called the Government, in the penal sum of the amount stated above, for the payment of which sum well and truly to be made, we bind ourselves, our heirs, executors, administrators, and successors, jointly and severally, firmly by these presents.

THE CONDITION OF THIS OBLIGATION IS SUCH, that whereas the principal entered into a certain contract with the Government, numbered and dated as shown above and hereto attached;

NOW THEREFORE, if the principal shall well and truly perform and fulfill all the unddertakings, covenants, terms, conditions, and agreements of said contract during the original term of said contract and any extensions thereof that may be granted by the Government, with or without notice to the surety, and during the life of any guaranty required under the contract, and shall also well and truly perform and fulfill all the undertakings, covenants, terms, conditions, and agreements of any and all duly authorized modifications of said contract that may hereafter be made, notice of which modifications to the surety being hereby waived, then, this obligation to be void; otherwise to remain in full force and virtue.

IN WITNESS WHEREOF; the above-bounden parties have executed this instrument under their several seals on the date indicated above, the name and corporate seal of each corporate party being hereto affixed and these pres-[fol. 22] ents duly signed by its undersigned representative, pursuant to authority of its governing body,

Corporate Principal
DUTCHER CONSTRUCTION CORPORATION

Business Address
Queenstown, Maryland

By RALPH E. DUTCHER — AFFIX CORPORATE SEAL
Title
President
Ralph E. Dutcher

Attest:

Ruth S. Dutcher
Secretary
Ruth S. Dutcher

Corporate Surety
Fire Association of Philadelphia
Business Address
Philadelphia, Pennsylvania

By James F. McCloskey — AFFIX CORPORATE SEAL
Title
Attorney-in-Fact
James F. McCloskey

Attest:

[fol. 23]

Exhibit "C" to Petition

PAYMENT BOND

(See Instructions on Reverse)

Standard Form 25-A
Revised November 1959
Prescribed by General
Services Administration
General Regulation No. 5

Date Bond Executed
11 April 1955

Principal
DUTCHER CONSTRUCTION CORPORATION, a Delaware Corporation, of Queenstown, Maryland

Surety
FIRE ASSOCIATION OF PHILADELPHIA, a Pennsylvania Corporation, of Philadelphia, Pennsylvania

Penal Sum of Bond *(express in words and figures)*
Eight Hundred Seventy-nine Thousand One Hundred Thirty-seven and 20/100 ($879,137.20) Dollars

Contract No.
DA-30-023-eng-339

Date of Contract
11 April 1955

KNOW ALL MEN BY THESE PRESENTS, That we the PRINCIPAL and SURETY above named, are held and firmly bound unto the United States of America hereinafter called the Government, in the penal sum of the amount [fol. 24] stated above, for the payment of which sum well and truly to be made, we bind ourselves, our heirs, executors, administrators, and successors, jointly and severally, firmly by these presents.

THE CONDITION OF THIS OBLIGATION IS SUCH, that whereas the principal entered into a certain contract with the Government, numbered and dated as shown above and hereto attached;

NOW THEREFORE, if the principal shall promptly make payment to all persons supplying labor and material in the prosecution of the work provided for in said contract, and any and all duly authorized modifications of said contract that may hereafter be made, notice of which modifications to the surety being hereby waived, then this obligation to be void; otherwise to remain in full force and virtue.

IN WITNESS WHEREOF, the above-bounden parties have executed this instrument under their several seals on the date indicated above, the name and corporate seal of each corporate party being hereto affixed and these presents duly signed by its undersigned representative, pursuant to authority of its governing body.

Corporate Principal
DUTCHER CONSTRUCTION CORPORATION
Business Address
Queenstown, Maryland

By RALPH E. DUTCHER
Title
President
Ralph E. Dutcher

AFFIX
CORPORATE
SEAL

[fol. 25] Attest:

RUTH S. DUTCHER
Secretary
Ruth S. Dutcher

-7

Corporate Surety
FIRE ASSOCIATION OF PHILADELPHIA
Business Address
Philadelphia, Pennsylvania

By JAMES F. MCCLOSKEY
Title
Attorney-in-Fact
James F. McCloskey

AFFIX
CORPORATE
SEAL

Attest:

IN UNITED STATES DISTRICT COURT

AGREED STATEMENT OF FACTS

The Reliance Insurance Company (formerly known as Fire Association of Philadelphia) upon its petition to this Court, verified September 4, 1959, having duly procured from this Court an order to show cause dated September 21, 1959, requiring the Trustee herein, creditors and others interested in the estate of the above named bankrupt, to show cause before this Court on October 14, 1959, why an order should not be made directing the Trustee herein to forthwith pay over to said Reliance Insurance Company the sum of $87,737.35, being the proceeds of a payment by the U. S. Engineers, received and now held by the T[illegible] [fol. 26] for work, labor and services render[illegible] and performed by the bankrupt, as the prime contra[illegible] the St. Lawrence Seaway prime contract, known as Contract No. DA-30-023-eng-339, on which prime contract said Fire Association of Philadelphia—now known as Reliance Insurance Company—was surety under the Miller Act, so-called, 40 U. S. C. A., Secs. 270 ff;

And due and timely notice of said order to show cause having been given to the Trustee, creditors and others interested in the estate of the said bankrupt;

And upon the return day of said order to show cause said Reliance Insurance Company having appeared by its attorneys, Vaughan, Brown, Kelly, Turner and Symons, Mark N. Turner, Esq., of counsel, and Chester A. Pearl-

man, said Trustee having appeared in person and by his attorney, Raymond T. Miles, Esq.;

And there being no other appearances by or on behalf of any creditor or interested person asserting any claim against the aforesaid fund of $87,737.35;

Now, therefore, it is STIPULATED by and between the attorneys for the Trustee and the said Reliance Insurance Company that this Court decide and determine the issues presented by the petition of said Reliance Insurance Company and the order to show cause issued thereon, upon the following facts, which facts are hereby stipulated to be as follows:

1. That Reliance Insurance Company is an insurance corporation duly organized and existing under and by virtue of the laws of the Commonwealth of Pennsylvania, with its principal office and place of business located at 401 [fol. 27] Walnut Street, Philadelphia, Pennsylvania. That the name of the corporation, prior to January 1, 1958, was Fire Association of Philadelphia, and is hereinafter referred to as the "Surety".

2. That heretofore and on or about November 19, 1951, the Dutcher Construction Corporation, the bankrupt herein, made, executed and delivered to the Surety its certain General Indemnity Agreement, a copy of which is annexed to the petition of September 4, 1959, marked Exhibit "A", and is made a part of this stipulation.

3. That on or shortly prior to April 11, 1955, the bankrupt applied to the Surety for payment and performance bonds in connection with a prime contract then about to be entered into between the bankrupt and the United States of America, Corps of Engineers, relating to the St. Lawrence Seaway, and known as Contract No. DA-30-023-eng-339.

4. That in reliance upon Exhibit "A", the Surety, as surety for said bankrupt and not otherwise, on or about April 11, 1955, made, executed and delivered the payment and performance bonds herein referred to, a copy of which Performance Bond is attached to the petition of September

4, 1959, marked Exhibit "B", and a copy of which Payment Bond is attached to the petition of September 4, 1959, marked Exhibit "C", and both of which are made a part of this stipulation.

5. That upon the furnishing to and filing with the Corps of Engineers of said payment and performance bonds, the bankrupt was duly awarded said prime contract and entered upon the performance thereof.

[fol. 28] 6. That thereafter, and on or about April 11, 1956, the United States of America, with the consent of said bankrupt, terminated the aforesaid prime contract of April 11, 1955, and that on or about August 30, 1956, the bankrupt was adjudicated a bankrupt by this Court.

7. That the bankrupt, during its prosecution of said contract and prior to its termination on April 11, 1956, as aforesaid, incurred various bills for labor, materials and services in the performance of its said prime contract, which were covered by the Surety's payment bond, and that prior to April 11, 1956, said bankrupt was in default in the payment of substantial portions of said bills and obligations covered by the Surety's said payment bond.

8. That during the spring and summer of 1956, various demands were made upon the Surety by the several creditors of the bankrupt who were covered by said payment bond, and that pursuant to said demands and in discharge of its obligations and duties under said payment bond, the Surety paid to said beneficiaries under said payment bond the sum of Three Hundred Twenty-Six Thousand Two Hundred Forty-Eight Dollars and Forty-Two Cents ($326,248.42) and, in addition thereto, incurred and paid expenses in connection therewith, in the sum of Twenty Thousand Seven Hundred Fifty-Four Dollars and Thirty-Four Cents ($20,754.34), making a total of Three Hundred Forty-Seven Thousand Two Dollars and Seventy-Six Cents ($347,002.76).

9. That in addition to the foregoing, the Surety paid, in response to a judgment secured against it in the United States District Court for the Northern District of New York, the sum of Eighteen Thousand Eight Hundred Sev-

[fol. 29] enty-Eight Dollars and Forty-Seven Cents ($18,-878.47) for tires furnished to the bankrupt for use on said prime contract, by which judgment said Court held the Surety liable therefor, and the further sum of Four Thousand Forty-Five Dollars and Ninety-Two Cents ($4,045.92) to Credle Equipment, for which the Surety was liable under said payment bond, making a total of claim payments of Three Hundred Forty-Nine Thousand One Hundred Seventy-Two Dollars and Eighty-One Cents ($349,172.81).

That there now remains no known unpaid laborers or materialmen who furnished labor, materials or services in connection with the Dutcher prime contract.

10. That concurrently with the termination of the bankrupt's prime contract, the U. S. Engineers awarded to B. Perini & Sons, Inc. and others, constituting a joint venture, known and referred to as Grass River Lock Constructors, the unfinished portions of the Dutcher prime contract above referred to. That the termination of the Dutcher prime contract, and the addition of the unfinished work thereunder to the preexisting prime contract of Grass River Lock Constructors, was with the full knowledge and consent of the bankrupt.

11. That said Grass River Lock Constructors, in taking over the unfinished work originally included within the Dutcher price contract, agreed with the U. S. Engineers to complete the same at the Dutcher prime contract prices.

12. That concurrently with the termination of the Dutcher prime contract and the taking over of the unfinished work thereunder by Grass River Lock Constructors, said Grass River Lock Constructors entered into an agree-[fol. 30] ment with the bankrupt whereby said bankrupt became a subcontractor for said Grass River Lock Constructors to do and perform certain of the unfinished work originally included in the bankrupt's prime contract; and that for some period of time subsequent to April 11, 1956, the bankrupt performed certain work as a subcontractor of said Grass River Lock Constructors.

13. That said Fire Association of Philadelphia—now Reliance Insurance Company—was not, at any time, a

surety for said Grass River Lock Constructors, nor for the bankrupt herein, at any time while the bankrupt was working as a subcontractor for said Grass River Lock Constructors.

14. That the bankrupt, prior to the termination of its prime contract on April 11, 1956, had earned, in the performance thereof, sums in excess of One Hundred Twenty-Seven Thousand Seven Hundred Thirty-Seven Dollars and Thirty-Five Cents ($127,737.35). That after said Grass River Lock Constructors undertook the completion of the unfinished work originally included within the Dutcher prime contract, it was asserted by the Contracting Officer for the U. S. Engineers that the proper shaping and dressing of the spoil area was a part of the contract price for excavation, and that Dutcher had not properly completed the work in that respect. That Grass River Lock Constructors asserted it was entitled to be compensated out of the Dutcher prime contract moneys for grading the spoil area onto which the bankrupt had dumped said excavated material while working as a prime contractor.

15. That various conferences were had in which the Trustee herein and his attorney, the Surety herein and [fol. 31] its attorney, Grass River Lock Constructors and its attorney, and the U. S. Engineers and their attorney, participated. That during said conferences it was the consensus of opinion that Forty Thousand Dollars ($40,000.00) was a fair price for doing this work, and represented a fair deduction from the contract price of the Dutcher contract, and a fair addition to the contract of Grass River Lock Constructors for completing the work. That neither the Trustee nor the Surety interposed any objection to Forty Thousand Dollars ($40,000.00) being taken from the Dutcher prime contract moneys and paid to said Grass River Lock Constructors for grading said spoil areas. That thereafter the U. S. Engineers, acting unilaterally, deducted Forty Thousand Dollars ($40,000.00) from the Dutcher prime contract moneys and directed the same be paid to the Grass River Lock Constructors for grading said spoil areas.

16. That the U. S. Engineers, after making the aforesaid Forty Thousand Dollar ($40,000.00) deduction from the Dutcher prime contract moneys, and after satisfying and discharging all its other claims and demands relating to all work performed by the bankrupt under its said prime contract, paid to the Trustee of the bankrupt the sum of Eighty-Seven Thousand Seven Hundred Thirty-Seven Dollars and Thirty-Five Cents ($87,737.35) for work performed by the bankrupt on its prime contract prior to April 11, 1956, which said sum the Trustee now holds, and which is the subject of this stipulation, and the ownership of which is now before this Court for determination.

17. That subsequent to the bankruptcy of the bankrupt, and within the time required by law, and on or about March [fol. 32] 22, 1957, the Surety duly filed its claim against the bankrupt herein with the Referee in Bankruptcy of this Court, to which reference is hereby made, and which is incorporated herein by reference as though fully set forth herein.

18. That in and by said claim the Surety asserted a first priority: 1) in the aforesaid sum of Three Hundred Forty-Seven Thousand Two Dollars and Seventy-Six Cents ($347,002.76), together with 2) such additional sums as it might pay or be compelled to pay in the discharge of its obligations under the aforesaid payment bond, which amount was, at the time of filing said claim, contingent and unliquidated, but which has now become liquidated and fixed, at least to the extent of the payment of said judgment, in the aforesaid sum of Eighteen Thousand Eight Hundred Seventy-Eight Dollars and Forty-Seven Cents ($18,878.47), and the further sum of Four Thousand Forty-Five Dollars and Ninety-Two Cents ($4,045.92), as aforesaid.

19. That in and by said proof of claim the Surety further asserted:

"That as to the aforementioned debt, both liquidated, unliquidated and contingent, this creditor claims and asserts it is entitled to priority in the payment thereof,

including by way of liens, subrogation and assignment, from the following sources:

1. Unpaid contract balances, including all estimates, retainages, extras, claims for changed conditions, damages and final estimates unpaid under the bankrupt's aforesaid prime contract with the United States of America, Corps of Engineers, as afore- [fol. 33] said, together with any and all other recoveries, if any, made by the Trustee in Bankruptcy herein on behalf of said bankrupt, growing out of or pertaining in any manner to the aforesaid prime contract with the United States of America, Corps of Engineers."

20. That by virtue of the foregoing, the Surety claims to be the owner of said sum of Eighty-Seven Thousand Seven Hundred Thirty-Seven Dollars and Thirty-Five Cents ($87,737.35), free and clear of the claims of the Trustee in Bankruptcy or any other person, firm or corporation, and claims to be entitled to have said sum paid to it forthwith.

Dated: Buffalo, New York, January ......, 1960.

Raymond T. Miles, Attorney for Chester A. Pearlman, Trustee in Bankruptcy of Dutcher Construction Corporation, Bankrupt.

Vaughan, Brown, Kelly, Turner & Symons, Attorneys for Reliance Insurance Company, Surety.

[fol. 34]

IN UNITED STATES DISTRICT COURT

OPINION OF REFEREE PRIVITERA

Raymond T. Miles, attorney for Trustee.

Vaughan, Brown, Kelly, Turner & Symons; Mark N. Turner, of Counsel, attorneys for Reliance Insurance Co. (formerly Fire Association of Philadelphia).

Saperston, McNaughtan & Saperston; Harry H. Wiltse, of Counsel, attorneys for James F. Mc Closkey, Inc.

Privitera, Referee.

I

This is an application of the Reliance Insurance Company (formerly Fire Association of Philadelphia) for an order directing the trustee to pay to petitioner the sum of $87,737.35, as a priority claim being the proceeds of a payment by the U. S. Engineers, received and now held by the trustee, covering work, labor and services rendered and performed by the bankrupt on the St. Lawrence Seaway Prime Contract, known as Contract No. DA-30-023-eng-339, and on which the petitioner was surety for said bankrupt. Upon due notice to all creditors a hearing was held and opposition to the requested payment was made by the trustee. Thereafter and from time to time this court received letters from several unrepresented creditors opposing the surety's application. Another creditor, James F. Mc Closkey, Inc. was later permitted to appear and oppose the application through its new counsel; since it appeared that the original proof of claim No. 29 (amended by claim No. 55) was previously filed by the surety's counsel who thereafter informed James F. Mc Closkey Inc. of his withdrawal as its counsel when it appeared that a conflict of interest arose.

[fol. 35] On February 15, 1960, the surety and the trustee through their respective counsel entered into a lengthy and detailed written stipulation of facts and incorporated therein as exhibits, copies of the general indemnity agreement between the bankrupt and the surety, and the payment and performance bonds.

II

Briefly, the salient facts of the said stipulation are as follows:

On November 19, 1951, the bankrupt executed and delivered to the Fire Association of Philadelphia its general indemnity agreement.

Subsequently, in 1955 the bankrupt executed a contract with the United States Corps of Engineers relating to the construction of the St. Lawrence Seaway. In connection

with this contract, the bankrupt furnished to the Corps of Engineers payment and performance bonds issued by the Fire Association of Philadelphia on or about April 11, 1955. The latter is now named the Reliance Insurance Company.

The bankrupt entered into performance of its contract with the Corps of Engineers and incurred bills for labor, materials and services which are covered by the surety company's payment bond. Upon the contractor's default in the early part of 1956, the surety company was compelled to pay a number of said bills pursuant to its payment bond. The total so paid was $326,248.42 and the surety further claims expenses in connection with said payments of $20,754.34, and other payments of $22,924.39. [fol. 36] However, on or about April 11, 1956, the United States with the bankrupt's consent terminated its contract with the bankrupt.

Shortly thereafter and on August 30, 1956, the Dutcher Construction Corporation was adjudicated a bankrupt. Concurrently with the termination of the bankrupt's contract with the United States, the latter with the consent of the said bankrupt, awarded the unfinished portion (spoil area) of the bankrupt's contract to Grass River Lock Constructors, a joint venture of several corporations which agreed with the U. S. Engineers to complete the same at the Dutcher prime contract prices. Grass River Lock Constructors, at the time it entered into performance of the work left unfinished by the bankrupt, also agreed to do certain work for the sum of $40,000.00 which work according to the United States should have been done prior to the termination of the bankrupt's contract, said $40,000.00 to be a charge against the sum of $127,737.35 previously earned by the bankrupt and retained by the United States at the time of the termination of the bankrupt's contract. After April 11, 1956, the bankrupt performed work as a subcontractor for the said Grass River Lock Constructors.

However, the Fire Association of Philadelphia, now Reliance Insurance Company, was not, at any time, a surety for said Grass River Lock Constructors, nor for the bank-

rupt herein, at any time while the bankrupt was working as a subcontractor for said Grass River Lock Constructors.

Various conferences were had in which the trustee herein and his attorney the surety herein and its attorney, Grass River Lock Constructors and their attorney and the U. S. [fol. 37] Engineers and their attorney participated. It was the consensus of opinion that $40,000.00 was a fair price for doing this work. That neither the trustee nor the surety objected to this sum being taken from the Dutcher prime contract monies and paid to said Grass River Lock Constructors for grading the spoil areas. Thereafter, the U. S. Engineers, acting unilaterally, paid the said sum to the Grass River Lock Constructors; leaving a balance retained by the United States in the amount of $87,737.35 which was thereafter paid to the trustee.

It is this sum to which the surety company asserts its claim to priority of payment.

III

This case once again brings before this court for determination the claim of a surety for priority payment by way of alleged liens, subrogation and assignment. The difficulty in arriving at a decision stems from the conflicting opinions of the many appellate courts. Prior to the enactment of the Miller Act, it seems in all cases respecting United States Government contracts that the only requirement made of a contractor was that he furnish a performance bond. However, under the Miller Act, the contractor is required to furnish a payment bond and a performance bond. Why the two separate bonds?

A study of the many conflicting opinions shows that a thread of distinction has been made, but not always clearly. In some instances, some courts seem to have made no distinction as to the rights of a surety in the treatment of the circumstances respecting either of the type of bonds, while other courts have made some distinctions.

[fol. 38] Here at least, in the case at bar, we have a clear case involving the payment bond only, since the balance of the contract was taken over by another contractor other than the bankrupt and the bankrupt's surety was not the surety for the other contractor. The surety here, to be

successful in its claim to priority payment, must establish a lien, subrogation rights to one entitled to a priority, or an assignment from one entitled to a priority.

While the surety's proof of claim asserts a priority claim by way of lien, no argument has been made in the various memoranda presented to this court, nor does one seem to exist under any theory from the stipulated facts herein.

Generally, in a construction contract between private parties those who furnish labor and/or materials and supplies have under state laws a right to a lien on the improvement and land which must be perfected in accordance with statutory provisions to secure payment of their claims.

However, when a construction of a project is undertaken by a contractor for the United States Government, no liens can be filed by laborers or materialmen and the United State Government is under no legal liability to pay laborers or materialmen. Since the latter are denied the right to assert liens, the United States Congress in order to afford them some protection passed the Miller Act, which carries forward prior similar acts in addition to enlarging upon them by requiring the contractor to furnish two bonds, a payment bond for the payment of laborers and materialmen, and a performance bond to guarantee the faithful completion of the job at the contract price. See Miller Act, 49 Stat. 793, 40 U. S. C. A. Sec. 270a *et seq.*; *National Surety Corp. v. United States*, 133 F. Supp. 381.

[fol. 39] Since the laborers and materialmen have no right to a lien by reason of the foregoing, they do not occupy any better position than that of general creditors against a contractor. Hence, when the surety is called upon to pay these claims, it is merely paying claims of general creditors. It follows, therefore, that since the laborers and materialmen have no liens or right to liens in Miller Act cases that the surety upon payment pursuant to the payment bond cannot under any theory claim a lien either. *Phoenix Indemnity Company v. Earle*, 218 F. 2nd 645 (1955); *American Surety Company of New York v. Hinds*, 260 F. 2nd 366 (1958).

Let us now pass to the claims of subrogation and/or assignment. One of the few clear cut cases which brings into sharp focus the rights of a surety who furnished a

payment bond is MATTER OF MILE HIGH PLUMBING & HEATING CO., BANKRUPT, CASE NO. 14797, originating in the United States District Court for the District of Colorado in the Tenth Circuit and decided by Referee B. C. Hilliard, Jr. The facts in that case are clearly similar to those in the case at bar.

This well-reasoned opinion is reported on Page 65 of the 1958 April issue of The Journal of National Association of Referees in Bankruptcy. This decision was affirmed by the District Court and upon appeal was unanimously affirmed by the Tenth Circuit United States Court of Appeals on October 11, 1958 *sub nom. American Surety Co. of N. Y.* v. *Oscar Hinds*, 260 F. 2nd 366.

In that case as in the case at bar, the single question presented was: Did the surety by reason of its payment [fol. 40] of labor and material bills incurred by the contractor prior to its adjudication as a bankrupt acquire any rights to the net contract funds superior to the rights of the trustee?

The answer to that question in this case must of necessity be the same as in that case.

> "The rights of a surety are largely derivative in nature. Having paid the laborers and materialmen, appellant may claim subrogation to their rights. But since laborers and materialmen have no enforceable rights against the United States (*U. S.* v. *Munsey Trust Co.*, 332 U. S., Page 241) the surety can rise no higher than the basis of the subrogation. The very purpose of the payment bond required under the Miller Act is to shift the ultimate risk of non-payment from the workmen and the suppliers to the surety." *American Surety Co. of N. Y.* v. *Hinds, supra.*

In other words, the United States does not retain funds for the purpose of assuring payment to laborers and material suppliers since "it seems more likely that completion of the work on time is the only motive". See citations in Munsey case, *supra*, at Page 243.

The court in the Hinds case, *supra*, in Footnote 5 at Page 368 states: "We are not required to consider v ether a

different rule might be applicable were a claim made under a performance bond."

It may well be that under a payment bond the surety is to be considered as a guarantor, assuming the risk for a premium payment to pay laborers and suppliers of material who have no lien rights against the United States Government in cases where the Government is the owner. [fol. 41] But, however, to point up the distinction, for the sake of clarity, it may be suggested that under a performance bond, the situation might be different since the surety takes over *completion* of the construction in substitution of the defaulting contractor and hence, is primarily responsible in creating the fund to which it becomes entitled over the trustee, assignees of the bankrupt, etc., absent any right to set-off by the Government. See Phoenix Indemnity Co. v. Earle, *supra*. And, even where the contractor had completed 94.86% of the agreed work before bankruptcy, but the job was completed by the trustee, the court in the Hinds case denied relief to the surety who paid all of the material and labor bills incurred by the contractor.

The holding in the Hinds case, *supra*, is firmly supported by the Munsey case, *supra*. In fact, the Munsey case uses much stronger language in dispelling the notion that a surety can become entitled to priority payment by way of subrogation, when it states at Page 242:

> "In relying on the rights of the laborers and materialmen, however, the surety must establish that those rights existed before their claims were paid. For it is elementary that one cannot acquire by subrogation what another whose rights he claims did not have. *Once the laborers and materialmen have been paid, either by the contractor or surety, they have no rights in any fund.* If before they are paid, the fund they are said to be entitled to look is unavailable for the very reason that they are unpaid, the surety relies on nothing when it relies on these nonexistent 'rights'. One who rests on subrogation stands in the place of one whose claim he has paid, as if the payment giving rise to the [fol. 42] subrogation had not been made. *See Aetna Life Assurance Co.* v. *Middleport*, 124 U. S. 534, 548.

He cannot jump back and forth in time and present himself at once as the unpaid claimant, and again, under the conditions as they have changed, because payment was made."

See Pages 243-244, Munsey case, where the court in unmistakable language stated:

"On the contrary, the statutory provisions requiring a separate bond for payment of laborers and materialmen were enacted for their benefit, not to the detriment of the Government. *It is the surety who is required to take the risk.* In the case of the laborers' bonds, the surety has promised that they will be paid, not as in the case of the performance bond, that work will be done at a certain price. The law of damages is, therefore, not pertinent to the payment bond."

The situation apparently is different where a surety in a Miller Act case takes over the *completion* of the contract under the performance bond and furnishes new and contemporaneous consideration sufficient to support collection of payments due on account of the contract. *Pacific Indemnity Co.* v. *Grand Avenue State Bank of Dallas,* 223 F. 2nd 513, C. C. A. 5th 1955. This is even true where a surety finances and supervises the contractor's operations to complete the contract at the contract price. *Massachusetts Bonding and Ind. Co.* v. *State of New York,* 259 F. 2nd 33, C. C. A. 2nd July 11, 1958.

If the Munsey case means what it says, the retained percentage or other monies which the Government holds (or [fol. 43] turns over to the trustee) not being a fund held by the Government for the benefit of the laborers or materialmen, since it owes them nothing, but the said fund is held for the purpose of insuring the faithful performance of the contract *in toto,* and the said fund is nonexistent insofar as the laborers and materialmen are concerned, and that the said claimants are only general creditors under the Miller Act, that the surety, upon demand to fulfill its obligation under the payment bond, is doing nothing more than required under the calculated risk it undertakes in con-

sideration of the premiums paid it by the contractor, and that upon payment by it to the claimants, it becomes subrogated, if at all, to the said claimants' rights as general creditors only, in an ensuing bankruptcy proceeding.

Thus the surety is not being denied payment as such, but it shall stand in no better position than those it has paid or other general creditors of the bankrupt, excepting in a case where laborers or other recognized wage earners may be entitled to priority payment for wages earned within three months of the filing of a petition in bankruptcy. Sec. 57 i and Sec. 64 a (2) Bankruptcy Act.

The point is that the surety does not become entitled to any specific fund held by the Government, the bankrupt contractor or the trustee, since the fund as such does not exist for that purpose. See Munsey case and Hinds case, *supra*.

True the surety may stand in the shoes of the laborers and materialmen, call it subrogation or assignment. But the surety only holds a general claim against general assets held by the trustee and no preferred claim against a specific fund, or the cream of the general assets.

[fol. 44] The surety in its memoranda to this court, among other cases and in support of its position urges the application of the so-called Fago case which originated in this court and was finally decided by the Second Circuit *sub nom. Massachusetts Bonding and Insurance Co. v. State of New York*, 259 F. 2nd 33 (1958). That case is most interesting because of the varied problems presented therein. While there are many points of similarity to the case at bar, there also are many features of that case that are clearly distinguishable. It, in fact, supports the position of the trustee herein.

On the matter of subrogation, that case holds *inter alia*, that where the United States asserted its set-off right to satisfy the payment of taxes due it from the bankrupt out of money earned by the bankrupt, that the surety did not acquire any right of subrogation to the position of the United States, for it said on page 36:

> "But the surety cannot establish this fact, for under the doctrine of *United States v. Munsey Trust Co.*

> * * *, neither the bankrupt nor the surety ever became entitled to those funds, so that there was nothing for the surety to own. In short, the surety by way of subrogation might be entitled to progress payments and retained percentage, due its principal *if the surety completes the job after the principal's default.* (Citing numerous authorities.)"

The point made above is twofold; first, that neither the bankrupt nor the surety ever became entitled to those funds since the retained percentages are held as assurance for the completion of the contract, so that there was nothing for the surety to own, and second, that there is a definite [fol. 45] distinction in regard to rights and remedies of a surety who does not complete the contract as against a surety who does.

In the Massachusetts case, *supra*, while surety was denied subrogation to the Government's position after the Government availed itself of its set-off, the court in allowing the surety to recover the $9,500.00 from the trustee did so in the finding, first that the surety caused the *completion* of the job by financing it, and second that there was a conversion of those monies which were originally earned by the surety during the progress of the job's *completion.*

There is a parallel situation in the Massachusetts case with the Munsey case. In the former, the court held that since neither the bankrupt nor the surety ever owned the "retained percentages" fund, that therefore, there could be no subrogation when the government asserted its right to set-off, while in the latter, the court held that since the "retained percentages" fund was non-existent as far as laborers and materialmen were concerned, that the surety could be entitled to no more than them.

It is the reasoning in the United States Supreme Court Munsey case which is adopted by the Massachusetts case and the Hinds case, that is controlling in determining the issue in the instant case. All other cases cited by the surety in its memoranda are not controlling, but are distinguishable inasmuch as they deal with situations affecting a determination of rights between the sureties and assignees of the bankrupt, cases decided under statutes antedating

the Miller Act; and also situations where the sureties *completed* the contracts in addition to making payments to [fol. 46] laborers and materialmen. Most of these cases are also distinguished or discredited in the Munsey and Hinds cases.

IV

As stated in the Munsey case, that the United States does not hold the "retained percentages" fund for the purpose of assuring payment to laborers and material suppliers since "it seems more likely that the completion of the work on time is the only motive", it can then be said that the key to the surety's rights to that fund, absent the right of the government to set-offs, and proper claims of other parties, is the completion of the contract. To put it another way, the funds are held "*in terrorem*" and in a state of suspension awaiting the final satisfactory completion of the contract by the contractor at the contract price. These funds do not become due and payable until that time.

When the surety pays the suppliers of labor and material pursuant to its obligations under the payment bond (for which it received cash consideration in the premium paid to it by the contractor) it is merely extinguishing the risk which it undertook to guarantee their payment under the Miller Act.

If on the other hand, these same payments were made while the surety was fulfilling its obligation under the performance bond; then and in that event, absent again the government's right of set-off, and proper claims of other parties, the surety would under the Massachusetts case doctrine, become entitled to the said "retained percentages" fund.

[fol. 47] It is to be noted that the Munsey case did not limit itself to a discussion of the payment bond. It did in very clear language state *inter alia* that a job must be completed by the contractor at its contract price, before the "retained percentages" can be paid to it. However, although the Hinds case squarely had the same problem presented before it as in the case at bar, it limited its decision to a discussion of the payment bond only. It did not venture to digress by *obiter dictum*, if it would be such,

"whether a different rule might be applicable were a claim made on a performance bond". In doing so it can be said that the court properly limited itself to an adjudication of the precise point before it. However, since it had an opportunity to do so, and had it discussed the surety's right under a performance bond in augmenting its decision, it would indeed have aided and facilitated the present task of this court. Where appeals are frequent there should be a strong tendency by the appellate courts in these modern times to fortify the judgment rendered, with every principle that can be invoked in its behalf, those that are collateral as well as those that are necessarily involved. It is not infrequent in the courts of last resort where there are many judges, that while a court may come to one and the same conclusion, that nevertheless various views might be expressed by different judges. These views, while they might sometimes be philosophical, they none the less to a great degree enhance the strength of the rendered judgment. The above, of course, is unnecessary to this opinion, but it is offered by way of explanation and not apology why this court did discuss some aspects of the performance bond.

Since a case on a lower court originates on a broader base, it is felt that such a discussion places this decision [fol. 48] relating to the rights of a surety under a payment bond, in better perspective. It is difficult to attempt to render a decision on one without an understanding of the other, since both bonds are required simultaneously when a Miller Act contract is awarded.

V

I conclude, therefore, that where a surety who furnishes a payment bond to assure payment to laborers and suppliers of material of a contractor engaged in construction work for the United States Government and which bond is furnished pursuant to the requirements of the Miller Act, whereunder the said laborers and materialmen cannot file liens against the government owner or the contractor, and the said contractor has not *completed* its contract or the surety has not completed the same or caused it to be com-

pleted, that the said surety upon making payments to the laborers and materialmen pursuant to its payment bond becomes subrogated to the rights of the said laborers and materialmen as a general creditor only in their place and stead, and where funds held by the government are turned over to the trustee in bankruptcy, the said surety which made the payments aforesaid does not become entitled to a priority in advance of general creditors, except possibly for claims of those wage earners that it has paid which wages might have been earned within the limits of the statutory three months period preceding the filing of a petition in bankruptcy.

VI

The foregoing having been considered upon the stipulated facts and conclusions of law drawn therefrom, it is

[fol. 49] Ordered, that the application of the Reliance Insurance Company (formerly Fire Association of Philadelphia) directing the trustee to pay to it the specific sum of $87,737.35, the proceeds received from the United States Engineers as a priority claim be and the same hereby is denied, and it is further

Ordered, that the said claim be and the same hereby is allowed as a general claim, excepting that portion of the claim which can be proven as an assignment of wages in accordance with the statute.

James R. Privitera, Referee in Bankruptcy.

Dated at Buffalo, New York, January 9, 1961.

It Is So Ordered.

In United States District Court

Petition to Review Referee's Decision—January 13, 1961

To Honorable James R. Privitera, Referee in Bankruptcy:

The petition of Reliance Insurance Company (formerly Fire Association of Philadelphia) respectfully represents:

1. Your petitioner is aggrieved by the Order-Opinion of James R. Privitera, Referee in Bankruptcy, dated January 9, 1961, a copy of which is annexed hereto, marked Exhibit "A", and made a part nereof.

2. The referee erred with respect to said order as follows:

[fol. 50] (a) In that he failed to direct the payment to petitioner of the sum of \$87,737.35, as the property of the petitioner.

(b) In that he failed to award the item referred to in sub-paragraph "(a)" hereof to petitioner, by way of its lien, subrogation and/or assignment rights.

(c) In that he failed to award the aforesaid sum as a priority claim.

(d) In that he relegated petitioner's claim with respect to the said \$87,737.35 to the status of a general creditor.

(e) In that he failed to grant to the petitioner the relief to which it was entitled.

Wherefore, petitioner prays that the Order be reviewed by a Judge in accordance with the provisions of the Act of Congress relating to bankruptcy. That said Order be modified in accordance with the specifications herein set forth, and that your petitioner have such other and further relief as is just.

Dated: January 13, 1961.

Reliance Insurance Company, By Addison Roberts, Its Vice President.

Vaughan, Brown, Kelly, Turner & Symons, Attorneys for Petitioner, By Mark N. Turner, Partner, Office & P. O. Address, 440 M & T Building, Buffalo 2, New York.

[fol. 51] To:

Hon. James R. Privitera, Referee.

Raymond T. Miles, Esq., Attorney for Trustee.

Saperston, McNaughtan & Saperston, Attorneys for James F. McCloskey, Inc.

IN UNITED STATES DISTRICT COURT

REFEREE'S CERTIFICATION OF RECORD ON REVIEW—
January 27, 1961

To the Honorable Judges of the District Court of the United States for the Western District of New York:

I, James R. Privitera, Referee in Bankruptcy herein, on the Petition to Review an order dated January 9, 1961 made by me hereby certify as follows:

1. Petition for Review of Reliance Insurance Company (formerly Fire Association of Philadelphia), dated January 13, 1961.

2. Opinion and Order of Referee dated January 9, 1961.

3. Agreed statement of Facts between Counsel dated February 15, 1960.

4. All copies of Exhibits considered in the Opinion are transmitted separately and consist of the following which are attached to and made part of the original petition and order to show cause dated [fol. 52] September 24, 1959 and returnable on October 14, 1959:

   Exhibit A—General Indemnity Agreement
   Exhibit B—Performance Bond
   Exhibit C—Payment Bond

The questions presented are the alleged errors of law set forth in the Petition for Review, the facts not being controverted.

Respectfully submitted,

James R. Privitera, Referee in Bankruptcy.

Dated: January 27, 1961.

IN UNITED STATES DISTRICT COURT

LETTER TO JUDGE HENDERSON FROM REFEREE PRIVITERA ENCLOSING AMENDED PROOF OF CLAIM

COPY

February 3, 1961

Hon. John O. Henderson,
United States Courthouse,
Buffalo 2, New York.

Re: Dutcher Construction Corp. No. 41068

Dear Judge Henderson:

Enclosed please find amended Proof of Claim, No. 133 of the Fire Association of Philadelphia whose name was later changed to Reliance Insurance Co.

[fol. 53] This proof of claim should be considered along with the other exhibits forwarded. It was referred to in the stipulation of facts entered into by Counsel and ~~enclosed~~ therein by reference.
incorporated

Respectfully yours,

James R. Privitera, Referee in Bankruptcy.

Enc.

IN UNITED STATES DISTRICT COURT

AMENDED PROOF OF CLAIM—Filed in Bkcy. Court March 22, 1957

Claim No. 133

At Philadelphia, in the District of Pennsylvania, on the 21st day of March, 1957, came Peter J. Korsan of 327 Callendar Lane, Wallingford, in the County of Delaware and Commonwealth of Pennsylvania, and made oath:

That he is the Secretary and Counsel of Fire Association of Philadelphia, an insurance corporation incorporated under and by virtue of the laws of the Commonwealth of Pennsylvania, with its principal office and place of business located at 401 Walnut Street, Philadelphia, Pennsylvania, and that he is duly authorized to make this proof.

That this claim is an amended claim to supplant its claim previously filed herein.

[fol. 54] That said Dutcher Construction Corporation, the corporation against whom a petition for adjudication in bankruptcy has been filed or made was at and before the filing of said petition, and still is justly and truly indebted to said corporation in the sum of $358,287.92.

That the consideration of said debt is as follows:

Losses paid as surety for the bankrupt on bankrupt's prime contract with the United States of America, Corps of Engineers, for certain work, labor and materials in connection with the St. Lawrence Seaway, being known and described as Contract No. DA-30-023-eng-339, to date as follows:

Claims paid	$326,248.42	
Expense payments	20,754.34	
		$347,002.76

Losses paid as surety for the bankrupt on bankrupt's subcontract with Johnson, Drake & Piper, Inc., in connection with the construction of a portion of the New York State Thruway in the vicinity of Westfield, New York, to date as follows:

Claims paid	$ 8,408.18	
Expense payments	2,876.98	
		$ 11,285.16
Grand Total		$358,287.92

[fol. 55] That in addition thereto, Fire Association of Philadelphia is and may be liable and compelled to pay on either or both of said bonds, as surety for said bankrupt, as aforesaid, additional losses and expenses, the amount and extent of which is not known and cannot be ascertained by this creditor at this time, and that this portion of this creditor's claim is filed as a contingent and unliquidated claim pursuant to Section 57d of the Bankruptcy Act.

That no part of said debt has been paid, that there are no set-offs or counterclaims to the same, and that this creditor has not nor has any person by its order or to the knowledge or belief of deponent for this creditor's use had or received any manner of security and for said debt whatever; that no judgment has been rendered on said debt; nor has any note been received for such account.

That said claim with respect to the liquidated portion thereof consists of numerous claims asserted against this claimant under the two (2) bonds referred to above given as surety for said bankrupt, and that the maturity date of said debts are various, commencing on or about June 15,

1956 and subsequent thereto, and that no note has been received nor judgment recovered therefor.

That as to the ~~following portion of the above debt,~~ aforementioned debt, both liquidated, unliquidated and contingent, this creditor claims and asserts it is entitled to priority in the payment thereof, including by way of liens, subrogation and assignment, from the following sources:

1. Unpaid contract balances, including all estimates, retainages, extras, claims for changed conditions, damages and final estimates unpaid under the bank- [fol. 56] rupt's aforesaid prime contract with the United States of America, Corps of Engineers, as aforesaid, together with any and all other recoveries, if any, made by the Trustee in Bankruptcy herein on behalf of said bankrupt, growing out of or pertaining in any manner to the aforesaid prime contract with the United States of America, Corps of Engineers.

2. Unpaid contract balances, including all estimates, whether retained or otherwise, and final balances, recovered or received by the Trustee in Bankruptcy herein, arising out of or pertaining in any manner to the bankrupt's sub-contract with Johnson, Drake & Piper, Inc., herein above referred to, together with any claims for extras, additional compensation or otherwise, arising out of said sub-contract.

That this deposition is not made by the claimant in person because claimant is a corporation and that this deponent is duly authorized by his principal to make this affidavit, and that it is within his knowledge that the aforesaid debt was incurred as and for the consideration above stated; and that such debt to the best of his knowledge and belief still remains unpaid and unsatisfied.

The undersigned creditor of the above named bankrupt hereby authorizes Brown, Kelly, Turner & Symons to attend any and all meetings of creditors of the bankrupt

aforesaid for and in the name of the undersigned, to vote for or against any proposal or resolution that may then be submitted under the Acts of Congress relating to bank-[fol. 57] ruptcy; and in the choice of Trustee or Trustees of the estate of said bankrupt; and for the undersigned to assent to such appointment of Trustees; also to accept any composition proposed by said bankrupt in satisfaction of his debts, and to receive payment of dividends; and of money due the undersigned under any composition; and for any other purpose in the undersigned's interest whatsoever with full power of substitution.

In Witness Whereof, the undersigned claimant has caused this Claim to be subscribed by its duly authorized officer and its corporate seal to be hereunto duly affixed the day and year above stated.

Fire Association of Philadelphia, By P. J. Korsan, Its Secretary & Counsel.

(Seal)

Duly sworn to by Peter J. Korsan, jurat omitted in printing.

[fol. 58]

IN UNITED STATES DISTRICT COURT

DECISION—September 12, 1961

Vaughan, Brown, Kelly, Turner & Symons (Mark Turner, of Counsel), Buffalo, New York, Attorneys for Petitioner, Reliance Insurance Company.

Miles, Cochrane & Grosse (Ray Miles, of Counsel), Buffalo, New York, Attorneys for Trustee in Bankruptcy.

The Reliance Insurance Company has petitioned for the review of a decision of the Referee in Bankruptcy relegating it to the position of a general creditor on claims for losses incurred under a payment bond given pursuant to the Miller Act, 49 Stat. 793 (1935), 40 U. S. C. § 270a (1958).

The Miller Act is the most recent of a series of acts designed to protect laborers and materialmen working on

government projects by requiring general contractors for the government to provide a surety bond guaranteeing payment of wages and material bills. Unlike the former legislation in the field,[1] the Miller Act separates the obligation of the general contractor to its laborers and materialmen from its obligation to the United States for the completion of the contract, accomplishing this by requiring two bonds—each designed to guarantee the respective obligation covered—in place of the single, combination performance and payment bond previously required. This change enhanced the bond protection of the laborers and materialmen by shortening the time within which they had to wait before suing on the bond and by divorcing the laborers' or materialmen's claim against a surety from any change of [fol. 59] consequences attendant upon the contractor's performance or non-performance of the construction contract itself.[2]

The surety in the case at bar rests its claim for priority upon a number of federal court cases beginning with *Henningsen v. United States Fidelity and Guaranty Company*, 208 U. S. 404 (1908), which recognized the right of a surety which had paid labor or material bills pursuant to its surety obligation to obtain recovery against any funds otherwise owing to the contractor by the government, but remaining in the hands of the government. Each of these

---

[1] The Heard Act, August 13, 1894, ch. 280, 28 Stat. 278, as amended by Act of February 24, 1905, ch. 778, 33 Stat. 811.

[2] The legislation preceding the Miller Act required the unpaid laborer or materialmen to wait until six months after the government had accepted the completed project, regardless when, during construction, the labor had been performed or the material provided. If at any time prior to this, the United States sued on the surety bond for default in performance of the contract by the contractor, the unpaid laborer or materialman could intervene in the action for the purpose of obtaining relief, but relief on his claim was postponed to that of the United States, and would be nonexistent if the claim of the United States was greater than the total amount of the bond.

[3] See, *e.g.*, *In re* Scofield Co., 215 Fed. 45 (2d Cir. 1914); *In re* P. McGarry & Son, 240 Fed. 400 (7th Cir. 1917); Belknap Hardware & Manufacturing Co. v. Ohio River Contracting Co., 271 Fed. 144 (6th Cir. 1921).

cases, although arising under the earlier legislation, involved situations like that at bar, where the payments made by the surety satisfied the contractor's default in paying labor and material bills and were not incurred by a default in completing the contract. Then, as now, the issue was whether, in providing the bond requirement in the statute, Congress intended to substitute the laborers' action upon the bond for any and all right against the United States or, on the other hand, intended merely to provide "an additional protection, which would become the ordinary and primary one, and usually would be sufficient, and to do this without diminishing the obligation of the government to [fol. 60] see that these claims were paid, as far as that result could be accomplished by the funds which it retained." *Belknap Hardware & Manufacturing Company* v. *Ohio River Contracting Company*, 271 Fed. 144, 148 (6th Cir. 1921). If the equitable right of the laborers and materialmen to look to the fund in the government's hands remained (in addition to the action upon the bond), the surety paying the laborers and materialmen could recover.

The answer of the courts before the enactment of the Miller Act was in favor of the surety. Whether that result has been changed by either the enactment of the Miller Act itself or by the effect of *United States* v. *Munsey Trust Company*, 332 U. S. 234 (1947) is the determinative issue in this case.

The enactment of the Miller Act would not seem to have affected the holding of the prior federal cases. Examination of the provisions of the legislation and of the discussions which took place on the floor of Congress when the Miller Act was passed[4] indicates that the purpose of Congress at that time was to remove certain loopholes in the bond protection previously accorded to laborers and materialmen—not to alter the fundamental rights and duties as between sureties, laborers and materialmen, and the government. Under the new legislation, laborers and materialmen could sue a surety upon a payment bond after

[4] 79 Cong. Rec. 11702 (1935) (remarks of Representative Miller): 79 Cong. Rec. 13382 (1935) (remarks of Senators Burke, Walsh and McCarran).

waiting only ninety days after the labor was performed or the material furnished [40 U. S. C. § 270b], rather than being required to wait until six months after the entire project had been completed and accepted by the govern- [fol. 61] ment. Moreover, under the new arrangement, satisfaction of the laborers and materialmen under the bond was not conditioned, as before, upon the prior satisfaction —perhaps by exhaustion of the penal sum of the bond itself—of the government for any default in performance of the contract. I conclude that the precedents antedating the Miller Act are as appropriate now, as before, unless, as the Referee held and as the Trustee now urges, the effect of the *Munsey* decision was to overrule the *Henningsen* line of authority.

While some cases support the Referee's decision on this point,[5] there is also considerable authority to the contrary.[6] In *Munsey*, the Supreme Court was confronted with a claim by a surety against funds held by the government which would have been due to the contractor, but for a set-off claimed by the government against the contractor. The United States was not in that case a mere stakeholder with no interest of its own to press, as it was in the *Henningsen* case and also here until it paid the sum to the trustee in bankruptcy. The holding in *Munsey*—that the government's

[5] American Surety Co. v. Hinds, 260 F. 2d 366 (10th Cir. 1958); Phoenix v. Earle, 218 F. 2d 645 (9th Cir. 1955); Fidelity & Deposit Co. v. N. Y. Housing Authority, 140 F. Supp. 298 (S. D. N. Y. 1956), rev'd on other grounds, 241 F. 2d 142 (2d Cir. 1957). Compare State Bank of Albany v. Dan-Bar Contracting Co., Inc., 23 Misc. 2d 487, 199 N. Y. S. 2d 309 (S. Ct. 1960), aff'd 12 A. D. 2d 416, 212 N. Y. S. 2d 386 (3d Dep't 1961).

[6] Cummins Construction Company, 81 F. Supp. 193 (D. C. Md. 1948); United States Fidelity and Guaranty Company v. Triborough Bridge Authority, 297 N. Y. 31 (1947); Royal Indemnity Company v. United States, 93 F. Supp. 891 (Ct. Cl. 1950); Hadden v. United States, 132 F. Supp. 202 (Ct. Cl. 1955); National Surety Corporation v. United States, 133 F. Supp. 381 (Ct. Cl. 1955), *cert. den.* 350 U. S. 902 (1955); Continental Casualty Company v. United States, 169 F. Supp. 945 (Ct. Cl. 1959); Newark Insurance Company v. United States, 169 F. Supp. 955 (Ct. Cl. 1959); Bank of Arizona v. National Surety Corporation, 237 F. 2d 90, 93 (9th Cir. 1956) (*dictum*).

claim to set-off was superior to the claim of a surety—does not require a conclusion that where the United States has [fol. 62] no set-off claim, the surety has no superior rights to the funds over general creditors. Indeed, such an extension of the *Munsey* decision would unwarrantably increase risk to the surety, whose guarantee has played a direct part in the production of the bankrupt's income here at issue and would further increase expense to the government through increased bond premiums passed on by the contractor as a cost of doing business. It seems sufficient to note that at no point in the *Munsey* decision did the Court mention *Henningsen* or the line of decisions which follow it. Had the Court intended by its language in *Munsey* to discard this prior authority, it is at least reasonable to assume that some discussion on the point would have been had.

The Referee's decision is set aside and his order of January 9, 1961, is vacated. The application of the Reliance Insurance Company for an order directing the trustee to pay to it the specific sum of $87,737.35, the proceeds received from the United States Engineers, as a priority claim is granted.

So ordered.

Dated: September 12, 1961.

John O. Henderson, United States District Judge.

[fol. 63]

IN UNITED STATES DISTRICT COURT

WESTERN DISTRICT OF NEW YORK

In the Matter

of

DUTCHER CONSTRUCTION CORPORATION, Bankrupt.

In Bankruptcy No. 41068

NOTICE OF APPEAL FROM JUDGE HENDERSON'S OPINION—
September 21, 1961

Notice is hereby given that Chester A. Pearlman, as Trustee in Bankruptcy, hereby appeals to the United States Court of Appeals for the second circuit from the order of Judge John O. Henderson entered the 12th day of September, 1961, which order reversed the decision of the Referee entered January 9, 1961, and granted the petition of the Reliance Insurance Company.

Buffalo, Sept. 21, 1961.

Raymond T. Miles, Attorney for Chester A. Pearlman, Trustee in Bankruptcy, Dutcher Construction Corporation, Office & Post Office Address, 942 Ellicott Square Building, Buffalo 3, New York.

[fol. 64] To:

Vaughan, Brown, Kelly, Turner & Symons, Attorneys for Reliance Insurance Company, Office & Post Office Address, 440 M & T Building, Buffalo, New York.

Saperston, McNaughtan & Saperston, Attorneys for James F. McCloskey, Inc., Office & Post Office Address, Liberty Bank Building, Buffalo 2, New York.

[fol. 65]

In United States District Court

Western District of New York

In the Matter

of

Dutcher Construction Corporation, Bankrupt.

No. 41068

Stipulation Concerning the Record—October 17, 1961

It Is Hereby Agreed and Stipulated by the respective attorneys for the parties herein, that all the papers cited in the Index on this appeal are the matters to be considered on this appeal and all other papers not so cited, are excluded.

October 17, 1961, Buffalo, N. Y.

Raymond T. Miles, Attorney for Chester A. Pearlman, Trustee in Bankruptcy of Dutcher Construction Corporation, Bankrupt.

Mark N. Turner, Vaughan, Brown, Kelly, Turner & Symons, Attorneys for Reliance Insurance Company.

[fol. 66]

IN UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 197—September Term, 1961,

Argued January 19, 1962

Docket No. 27246

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION, Bankrupt.

Before: Medina, Moore and Smith, Circuit Judges.

Appeal from an order of the United States District Court for the Western District of New York, in bankruptcy, John O. Henderson, Judge.

The trustee in bankruptcy appeals from an order directing him to pay to petitioner, Reliance Insurance Company, $87,737.35, a fund previously paid to the trustee by the United States for work performed by the bankrupt on its prime Government contract prior to the termination of said contract by mutual consent on April 11, 1956. The payment was directed on the basis of the subrogation of Reliance Insurance Company to priority rights of materialmen and laborers, who had been paid by Reliance Insurance Company pursuant to the terms of its payment bond, upon [fol. 67] the failure of the bankrupt to make such payments when due. Opinion below reported at 197 F. Supp. 441. Affirmed.

Raymond T. Miles, Buffalo, New York, for appellant, Chester A. Pearlman, Trustee in Bankruptcy of Dutcher Construction Corporation.

Mark N. Turner, Buffalo, New York (Vaughan, Brown, Kelly, Turner & Symons, Buffalo, New York, on the brief), for respondent, Reliance Insurance Company.

John G. Street, Jr., Fort Worth, Texas, filed a brief as *amicus curiae* supporting the contentions of appellant.

Thomas W. Murphy, Phoenix, Arizona (Murphy & Mirkin, Phoenix, Arizona), filed a memorandum as *amicus curiae* supporting the contentions of appellant.

Opinion—February 6, 1962

Medina, Circuit Judge:

The trustee in bankruptcy of Dutcher Construction Corporation appeals from an order of Judge Henderson, reversing the Referee and holding that petitioner-appellee Reliance Insurance Company (formerly named Fire Association of Philadelphia) was entitled to a fund of $87,737.35 previously paid by the Government to the trustee. Opinion below reported at 197 F. Supp. 441.

The case is interesting and important, as it involves the controversial question of whether a surety, having paid materialmen and laborers pursuant to the terms of a payment bond, but not having completed performance of work required by the prime contract with the Government, is [fol. 68] entitled by way of subrogation to the fund paid to the trustee in bankruptcy by the Government for the work done by the contractor prior to the termination of the contract. We think the legal principles formulated by the courts on this subject under the Heard Act, 28 Stat. 278 (1894), amended 33 Stat. 811 (1905), were not affected or altered by the Miller Act, 49 Stat. 793 (1935), 40 U. S. C. Section 270a, which superseded the Heard Act. With all due respect to our brothers of the 9th and 10th Circuits, we believe they have misconstrued the Supreme Court decision in *United States* v. *Munsey Trust Company*, 1947, 332 U. S. 234, and we disagree with the decisions in those Circuits holding the surety not entitled to subrogation. *Phoe-*

nier v. Earle, 9 Cir., 1955, 218 F. 2d 645; *American Surety Co. v. Hinds*, 10 Cir., 1958, 260 F. 2d 366.

The facts are stipulated. In April of 1955 Dutcher contracted with the United States to perform work on the Saint Lawrence Seaway project. Prior to awarding the contract, the Government required Dutcher to supply the customary surety bonds, a performance bond and a payment bond. This was done pursuant to the Miller Act, 40 U. S. C. Section 270a, which provides:

> "Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, which shall become binding upon the award of the contract to such person, who is hereinafter designated as 'contractor':
>
> (1) A performance bond with a surety or sureties satisfactory to the officer awarding such contract, and in such amount as he shall deem adequate, for the protection of the United States.
>
> [fol. 69] (2) A payment bond with a surety or sureties satisfactory to such officer for the protection of all persons supplying labor and material in the prosecution of the work provided for in said contract for the use of each such person.".

Reliance is the surety on these bonds.

On April 11, 1956 the Government, with the consent of Dutcher, terminated the contract. During the preceding year Dutcher incurred obligations to pay for labor and materials in the performance of the contract. Dutcher did not meet these obligations. The surety did pay them, in the amount of $326,248.42, for labor and materials, and additional sums for expenses, and in satisfaction of a judgment against the surety for tires furnished for use on the job, amounting in all to $349,172.81. These bills were paid by the surety in the Spring and Summer of 1956. At the end of August, 1956 Dutcher was adjudicated bankrupt.

Prior to the termination of the contract, Dutcher had earned, after Government deductions, $127,737.35 for the

work done up to that time, and this represented the labor and materials that had gone into the job. This sum, owing to Dutcher, was reduced by $40,000, the cost to the Government of completing the job. This consisted of the proper shaping and dressing of the spoil area. The balance, $87,737.35, was paid by the Government to appellant, as Trustee for Dutcher. The surety petitioned for an order in bankruptcy directing the transfer of this fund to the surety. The Referee, relying upon *Munsey* and the *Hinds* decision by the 10th Circuit denied the petition, and Judge Henderson reversed the Referee and held the surety entitled to the fund by subrogation. We affirm.

All parties agree that the surety is subrogated to the rights of the laborers and materialmen. What this entitles [fol. 70] the surety to is hornbook law and is set forth in Osborne, Suretyship (1955) at page 20, "It * * * entitles the surety to enjoy any priority that the creditor enjoyed." See also Restatement, Security §141, comment c. (1941). Thus, the only question in this case, and the decisive one, is—were the laborers and materialmen entitled to a priority in the $87,737.35?

Under the Heard Act

The Heard Act required a contractor entering on the construction of any public work for the United States shall "execute the usual penal bond, with good and sufficient sureties, with the additional obligations that such contractor or contractors shall promptly make payments to all persons supplying him or them labor and materials in the prosecution of the work provided for in such contract." 33 Stat. 812 (1905). In *Henningsen* v. *U. S. Fidelity & Guaranty Co.*, 1907, 208 U. S. 404, the surety which had paid materialmen and laborers upon the contractor's failure to do so, claimed a fund due from the Government as against a creditor of the contractor who held an assignment. It was argued by the creditor that the surety had no right prior to the assignment as the materialmen and the laborers had no lien on the Government property under construction, as the contractor and not the surety had completed performance under the contract, and as the material-

men and the laborers never had any right to the fund. In rejecting these contentions the Supreme Court held, 208 U. S. at page 410:

> "It [the surety] paid the laborers and material-men and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the [fol. 71] laborers and supply men were paid. It did this not as a volunteer but by reason of contract obligations entered into before the commencement of the work."

This would seem to be plain enough. But *Henningsen* was commented upon in *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 6 Cir., 1921, 271 Fed. 144, and the priority of materialmen and laborers spelled out in no uncertain terms, at pp. 148-9:

> "In that case [Henningsen], the surety upon a bond of this kind [a payment bond], given pursuant to the 1894 statute, and who had been compelled to pay its surety obligation, was held entitled to priority in the retained fund as against a general creditor of the contractor. * * * The surety's claim of priority in the fund was sustained, and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated."

The Miller Act

It is common knowledge that difficulties and inconveniences arose in the application of the Heard Act. For example, the unpaid materialmen and laborers had to wait until six months after the completion and final settlement of the contract before they could proceed against the surety.

If the Government instituted suit earlier, the laborers and materialmen could intervene, but shared only in the balance, if any, of the surety's liability remaining after the amount due the Government was paid in full. The legisla- [fol. 72] tive history of the Miller Act indicates clearly that the separate performance and payment bonds in their present form were substituted for the old law for the further protection of materialmen and laborers. See 79 Cong. Rec. 11702 (1935) (remarks of Representative Miller); 79 Cong. Rec. 13382 (1935) (remarks of Senators Burke, Walsh and McCarran). There is nothing to indicate that the priorities of the materialmen and laborers were intended to be eliminated, or affected in any way by the new provisions of the Miller Act. Under the Heard Act, and under the Miller Act as well, the security for the materialmen and laborers was to stand in place of a lien on the property under construction, as no lien attaches to Government property. The purpose under each of these Acts was the same, to encourage laborers and those furnishing materials to undertake the construction of the Government facility, and to make sure that those who did so and created the product under construction should be secured out of the job itself rather than on the general credit of the prime contractor.

It follows we think that the same priorities held to exist under the Heard Act continue to exist under the Miller Act. If the Government was under "equitable obligations to see that the laborers and supply men were paid" (208 U. S. at page 410), this would seem sufficient to support the claim of the surety for priority, and such "equitable obligations" surely are not less under the Miller Act than they were under the Heard Act. In this context, we think it quite immaterial that, after the termination of the contract, the little that remained to be done to complete the job was not done by the surety.

United States v. *Munsey*, 1947, 332 U. S. 234.

The decisions of the 9th and 10th Circuits in *Phoenix* and *Hinds* above referred to are based squarely on the premise [fol. 73] that the Supreme Court in *Munsey* had sustained

the Government's claim to a set-off partly because of "the weakness of the surety's claim to equitable rights in the fund." See *Hinds*, 260 F. 2d at page 368. Perhaps this impression stems from the following dictum in *Munsey*, 332 U. S. at page 242:

> "We need not decide whether laborers and materialmen would have any claim to the retained percentages if both contractor and surety failed to pay them. Even if they do, certainly those would be rights to which the surety could not be subrogated, for by hypothesis it would have done nothing to earn subrogation."

In any event, we think the quotations from *Munsey* in the opinions in *Phoenix* and *Hinds* have been misconstrued. If the Supreme Court intended to make any comment with respect to the situation now before us, it was merely to say they held the point open for decision in the future. Of course, if the surety failed to pay materialmen and laborers, the surety "would have done nothing to earn subrogation." Moreover, the fact that "laborers and materialmen have no enforceable rights against the United States," 260 F. 2d at page 368, is beside the point. The question is not whether the laborers and materialmen have rights enforceable against the Government, but whether they have an equitable priority in the retained payments.

In *National Surety Corporation v. United States*, Ct. Claims, 1955, 133 F. Supp. 381, cert. denied sub nom. *First National Bank in Houston v. United States*, 1955, 350 U. S. 902, the Court said at page 384:

> "[T]he laborers and materialmen have the equitable right to assert a claim to moneys in the hands of the defendant [the United States] which are due the contractor. When the surety pays the laborers and ma- [fol. 74] terialmen, it becomes subrogated to their right to assert an equitable claim to the moneys in the hands of the defendant. It has frequently been held that they have equitable priority to these moneys over the general creditors of the contractor and over his assignees. [Numerous citations omitted.]

In *United States* v. *Munsey Trust Co., supra,* the Supreme Court said that the United States was not legally liable to laborers and materialmen, but it did not say that laborers and materialmen could not assert an equitable claim to moneys in the hands of the United States payable under the contract. We think they can. To permit them to do so in no way interferes with the full exercise of the sovereign powers of the United States. It does not subject the defendant to liability beyond the amount it has in its hands confessedly due and owing to somebody."

Royal Indemnity Co. v. *United States,* Ct. Claims, 1950, 93 F. Supp. 891, is to the same effect.

The principle established by *Munsey* was that the Government's right to a set-off based on sums due from the contractor on other jobs was superior to any claim of the surety by way of subrogation. Furthermore, there is language in *Munsey* that justifies, if not compels, it to be limited to situations in which the United States is asserting a claim of its own to the retained funds. There are cases that have so held. E.g. *Royal Indemnity Co.* v. *United States, supra*; *United States Fidelity & Guaranty Co.* v. *Triborough Bridge Authority,* 1947, 297 N. Y. 31; and cases cited in *Hinds,* 260 F. 2d at 368.

It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and [fol. 75] subrogation that, as we have already pointed out, were so well established under the Heard Act. Certainly, there is not the slightest intimation that anything in the Miller Act was intended to change priorities existing under the prior legislation. See *United States* v. *Aetna Casualty & Surety Co.,* 2 Cir., decided January 11, 1962, Slip Sheet, at page 622. Accordingly, we disagree with *Phoenix* and *Hinds.*

We hold the surety entitled to the fund by subrogation; and the order appealed from is affirmed.

[fol. 76]

IN UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Present: Hon. Harold R. Medina, Hon. Leonard P. Moore, Hon. J. Joseph Smith, Circuit Judges.

In the Matter

of

DUTCHER CONSTRUCTION CORPORATION, Bankrupt,
CHESTER A. PEARLMAN, Trustee, Appellant.

JUDGMENT—February 6, 1962

Appeal from the United States District Court for the Western District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Western District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed.

[fol. 77] [File endorsement omitted]

[fol. 78] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 79]

SUPREME COURT OF THE UNITED STATES

No. 771, October Term, 1961

CHESTER A. PEARLMAN, Trustee, Petitioner,

vs.

RELIANCE INSURANCE COMPANY.

ORDER ALLOWING CERTIORARI—April 16, 1962

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Frankfurter and Mr. Justice White took no part in the consideration or decision of this application.

No. [redacted] 78

IN THE

Supreme Court of the United States

October Term—1962

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

PETITION FOR A WRIT OF CERTIORARI TO REVIEW AN ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AFFIRMING AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NEW YORK.

RAYMOND T. MILES,
LOWELL GROSSE,
Attorneys for Chester A. Pearlman,
Trustee in Bankruptcy of
Dutcher Construction Corporation,
942 Ellicott Square Building,
Buffalo 3, New York.

BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

INDEX.

Cases Cited

Statutes

IN THE

Supreme Court of the United States

October Term—1961

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

PETITION FOR A WRIT OF CERTIORARI TO REVIEW AN ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AFFIRMING AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NEW YORK

The petition of CHESTER A. PEARLMAN, Trustee in Bankruptcy of Dutcher Construction Corporation, respectfully shows:

(A) The opinion of the United States District Court for the Western District of New York is reported in 197 Fed. Supp. 441. The opinion of the United States Court of Appeals for the Second Circuit has not been reported.

(B) The jurisdiction of this court is invoked.

(1) The judgment of the United States Court of Appeals for the Second Circuit, which is sought to be reviewed, was entered on February 6, 1962, in the office of the Clerk of that court.

(2) The statutory provision believed by petitioner to confer on this court jurisdiction to review the judgment in question by writ of certiorari is that the United States Court of Appeals for the Second Circuit has rendered a decision in conflict with the decision of the United States Court of Appeals for the Tenth Circuit and the decision of the United States Court of Appeals for the Ninth Circuit, and the United States Court of Appeals for the Second Circuit has further decided a federal question in a way which is in conflict with the applicable decision of this court.

(C) The question presented for review is whether the Reliance Insurance Company, which paid certain laborers and materialmen for services and materials furnished to the Dutcher Construction Corporation prior to that corporation's bankruptcy, is entitled to be paid prior to general creditors of the bankrupt Dutcher Construction Corporation, the monies earned by Dutcher Construction Corporation prior to its bankruptcy and paid over by the United States of America subsequent to said bankruptcy to the Trustee in Bankruptcy of Dutcher Construction Corporation.

(D) The facts material to a consideration of the questions presented are as follows:

The bankrupt Dutcher Construction Corporation executed a contract with the United States Corps of Engineers for certain construction on the St. Lawrence Seaway and furnished to the Corps payment and performance bonds, both issued by the Fire Association of Philadelphia, now named the Reliance Insurance Company. This was done on or about April 11, 1955, and was pursuant to the Miller Act, 40 U. S. C. A., Secs. 270A-270D.

The bankrupt entered into performance of its contract with the Corps of Engineers and incurred bills for labor and materials which were covered by the payment bond issued by the surety company. The bankrupt never defaulted in the performance of the contract so far as the Corps of Engineers was concerned, but the contract between the bankrupt and the Corps was terminated on April 11, 1956, for the convenience of the Corps and with the consent of the bankrupt.

When the contract was terminated, the bankrupt had completed a very substantial part of the contract but it had run out of money and left approximately $326,248.42 of unpaid bills covered by the payment bond. These the surety proceeded to pay pursuant to the terms of the obligation of the payment bond. The surety further claims that it has expenses in connection with said payments of $20,754.34 and other payments of $22,924.99. The bills were paid by the surety in the spring and summer of 1956, and at the end of August, 1956, Dutcher Construction Corporation was adjudicated a bankrupt.

Subsequent to the termination of the contract with the Corps of Engineers, the Corps with the consent of the bankrupt corporation awarded the unfinished portion of the Dutcher contract to a joint venture of several corporations which agreed with the United States Corps of Engineers to complete the same at the Dutcher Construction Corporation prime contract price.

The joint venturers also agreed that they would do certain of the work which had been left unfinished by the bankrupt corporation for the sum of $40,000.00, said $40,000.00 to be a charge against the sum of $127,737.35 earned by the bankrupt and retained by the Corps of Engineers at the time of the termination of the bankrupt's contract.

Neither the Trustee nor the surety objected to this sum being taken from the Dutcher prime contract monies and, in fact, they agreed that this was a fair price to pay the joint venturers for the completion of the contract which should have been done by the bankrupt corporation. The joint ventures did complete their work and were paid $40,000.00, leaving a balance retained by the United States in the sum of $87,737.35. This sum was thereafter paid to the Trustee.

It is this sum of $87,737.35 to which the surety company asserts it has a right which is prior to the rights of the general creditors of the bankrupt corporation.

(E) The basis for federal jurisdiction in the court of first instance is that this is a matter involving a bankrupt corporation and its creditors.

(F) The United States Court of Appeals for the Second Circuit has ruled under the circumstances set forth above, that the surety, Reliance Insurance Company, is entitled to the fund paid by the United States of America to the Trustee in Bankruptcy. The court in its opinion admittedly has disagreed with the decisions of the United States Court of Appeals for the Ninth and Tenth Circuits and has stated in its opinion, per Medina, Circuit Judge, at page 68 of the record:

> "With all due respect to our brothers of the 9th and 10th Circuits, we believe they have misconstrued the Supreme Court decision in *United States v. Munsey Trust Company*, 1947, 332 U. S. 234, and we disagree with the decisions in those Circuits holding the surety not entitled to subrogation. *Phoenix v. Earle*, 9 Cir. 1955, 218 F. 2d 645; *American Surety Co. v. Hinds*, 10 Cir., 1958, 260 F. 2d 366."

Moreover, the United States Court of Appeals for the Second Circuit, after pointing out the reliance of the

United States Court of Appeals for the Ninth and Tenth Circuits upon certain language of the United States Supreme Court, in *United States v. Munsey*, 1947, 332 U. S. 234, has gone on to state that those courts have misconstrued the *Munsey* case, as witness the following quotation from the opinion on the United States Court of Appeals for the Second Circuit, at page 73 of the record:

> "In any event, we think the quotations from *Munsey* in the opinions in *Phoenix* and *Hinds* have been misconstrued."

And finally, the United States Court of Appeals, Second Circuit, after citing certain cases which preceded the decision of the United States Supreme Court, in *United States v. Munsey Trust Co., supra* has stated at page 74 of the record:

> "It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and subrogation that, as we have already pointed out, were so well established under the Heard Act. Certainly, there is not the slightest intimation that anything in the Miller Act was intended to change priorities existing under the prior legislation. See *United States v. Aetna Casualty & Surety Co.*, 2 Cir., decided January 11, 1962, Slip Sheet, at page 622. Accordingly, we disagree with *Phoenix* and *Hinds*."

Accordingly, there now exist decisions of the Ninth and Tenth Circuits which are in complete conflict with the Second Circuit in matters frequently before the United States Courts. As a matter of fact, a brief supporting the position of the petitioner was filed by counsel from Fort Worth, Texas, in the Fifth Circuit as *amicus curiae*, and a further memorandum was filed by counsel from Phoenix, Arizona, in the Ninth Circuit, as *amicus curiae* in this matter when it was before the United States Court of Appeals for the Second Circuit. Each of the counsel was concerned in a

matter involving the same legal question and very similar facts.

Since the decision of the United States Court of Appeals for the Second Circuit, the referee in bankruptcy of the United States District Court for the Northern District of Texas has rendered an opinion in *Stanford Construction Co.*, Bankrupt, in conformity with the *Hinds* case, *supra*, decided in the Tenth Circuit, and the *Phoenix* case, *supra*, decided in the Ninth Circuit. That decision is completely opposed to the decision herein which decision the referee specifically refused to follow.

The Trustee in Bankruptcy, therefore, contends that there should be a review of the judgment of the United States Court of Appeals for the Second Circuit on the ground that a matter of law only is involved and,

(1) There is a conflict between the decision of the United States Court of Appeals for the Second Circuit and the decisions of the United States Courts of Appeals for the Ninth and Tenth Circuits; and

(2) The basis for the conflict is the construction of the decision of the United States Supreme Court, in *United States* v. *Munsey Trust Co.*, 332 U. S. 234.

WHEREFORE, petitioner, CHESTER A. PEARLMAN, Trustee in Bankruptcy of Dutcher Construction Corporation, respectfully prays that this court issue a writ of certiorari to review the decision of the United States Court of Appeals for the Second Circuit.

CHESTER A. PEARLMAN,
Trustee in Bankruptcy of
Dutcher Construction Corporation.

By LOWELL GROSSE,
Counsel for Petitioner.

Appendix

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 197—September Term, 1961.

(Argued January 19, 1962 Decided February 6, 1962.)

Docket No. 27246

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

Before: MEDINA, MOORE and SMITH, *Circuit Judges.*

Appeal from an order of the United States District Court for the Western District of New York, in bankruptcy, John O. Henderson, *Judge.*

The trustee in bankruptcy appeals from an order directing him to pay to petitioner, Reliance Insurance Company, $87,737.35, a fund previously paid to the trustee by the United States for work performed by the bankrupt on its prime Government contract prior to the termination of said contract by mutual consent on April 11, 1956. The payment was directed on the basis of the subrogation of Reliance Insurance Company to priority rights of materialmen and laborers, who had been paid by Reliance Insurance Company pursuant to the terms of its payment bond, upon

the failure of the bankrupt to make such payments when due. Opinion below reported at 197 F. Supp. 441. Affirmed.

Raymond T. Miles, Buffalo, New York, for appellant, Chester A. Pearlman, Trustee in Bankruptcy of Dutcher Construction Corporation.

Mark N. Turner, Buffalo, New York (Vaughan, Brown, Kelly, Turner, & Symons, Buffalo, New York, on the brief), for respondent, Reliance Insurance Company.

John G. Street, Jr., Fort Worth, Texas, filed a brief as *amicus curiae* supporting the contentions of appellant.

Thomas W. Murphy, Phoenix, Arizona (Murphy & Mirkin, Phoenix, Arizona), filed a memorandum as *amicus curiae* supporting the contentions of appellant.

MEDINA, *Circuit Judge:*

The trustee in bankruptcy of Dutcher Construction Corporation appeals from an order of Judge Henderson, reversing the Referee and holding that petitioner-appellee Reliance Insurance Company (formerly named Fire Association of Philadelphia) was entitled to a fund of $87,737.35 previously paid by the Government to the trustee. Opinion below reported at 197 F. Supp. 441.

The case is interesting and important, as it involves the controversial question of whether a surety, having paid materialmen and laborers pursuant to the terms of a payment bond, but not having completed performance of work required by the prime contract with the Government, is entitled by way of subrogation to the fund paid to the trustee in bankruptcy by the Government for the work done by the contractor prior to the termination of the

contract. We think the legal principles formulated by the courts on this subject under the Heard Act, 28 Stat. 278 (1894), amended 33 Stat. 811 (1905), were not affected or altered by the Miller Act, 49 Stat. 793 (1935), 40 U. S. C. Section 270a, which superseded the Heard Act. With all due respect to our brothers of the 9th and 10th Circuits, we believe they have misconstrued the Supreme Court decision in *United States v. Munsey Trust Company*, 1947, 332 U. S. 234, and we disagree with the decisions in those Circuits holding the surety not entitled to subrogation. *Phoenix v. Earle*, 9 Cir., 1955, 218 F. 2d 645; *American Surety Co. v. Hinds*, 10 Cir., 1958, 260 F. 2d 366.

The facts are stipulated. In April of 1955 Dutcher contracted with the United States to perform work on the Saint Lawrence Seaway project. Prior to awarding the contract, the Government required Dutcher to supply the customary surety bonds, a performance bond and a payment bond. This was done pursuant to the Miller Act, 40 U. S. C. Section 270a, which provides:

> "Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, which shall become binding upon the award of the contract to such person, who is hereinafter designated as 'contractor':
>
> (1) A performance bond with a surety or sureties satisfactory to the officer awarding such contract, and in such amount as he shall deem adequate, for the protection of the United States.
>
> (2) A payment bond with a surety or sureties satisfactory to such officer for the protection of all persons

supplying labor and material in the prosecution of the work provided for in said contract for the use of each such person."

Reliance is the surety on these bonds.

On April 11, 1956 the Government, with the consent of Dutcher, terminated the contract. During the preceding year Dutcher incurred obligations to pay for labor and materials in the perforamnce of the contract. Dutcher did not meet these obligations. The surety did pay them, in the amount of $326,248.42, for labor and materials, and additional sums for expenses, and in satisfaction of a judgment against the surety for tires furnished for use on the job, amounting in all to $349,172.81. These bills were paid by the surety in the Spring and Summer of 1956. At the end of August, 1956 Dutcher was adjudicated bankrupt.

Prior to the termination of the contract, Dutcher had earned, after Government deductions, $127,737.35 for the work done up to that time, and this represented the labor and materials that had gone into the job. This sum, owing to Dutcher, was reduced by $40,000, the cost to the Government of completing the job. This consisted of the proper shaping and dressing of the spoil area. The balance, $87,737.35, was paid by the Government to appellant, as Trustee for Dutcher. The surety petitioned for an order in bankruptcy directing the transfer of this fund to the surety. The Referee, relying upon *Munsey* and the *Hinds* decision by the 10th Circuit denied the petition, and Judge Henderson reversed the Referee and held the surety entitled to the fund by subrogation. We affirm.

All parties agree that the surety is subrogated to the rights of the laborers and materialmen. What this entitles the surety to is hornbook law and is set forth in Osborne, Suretyship (1955) at page 20, "It * * * entitles the surety

to enjoy any priority that the creditor enjoyed." See also Restatement, Security § 141, comment c. (1941). Thus, the only question in this case, and the decisive one, is—were the laborers and materialmen entitled to a priority in the $87,737.35?

Under the Heard Act

The Heard Act required a contractor entering on the construction of any public work for the United States shall "execute the usual penal bond, with good and sufficient sureties, with the additional obligations that such contractor or contractors shall promptly make payments to all persons supplying him or them labor and materials in the prosectuion of the work provided for in such contract." 33 Stat. 812 (1905). In *Henningsen v. U. S. Fidelity & Guaranty Co.*, 1907, 208 U. S. 404, the surety which had paid materialmen and laborers upon the contractor's failure to do so, claimed a fund due from the Government as against a creditor of the contractor who held an assignment. It was argued by the creditor that the surety had no right prior to the assignment as the materialmen and the laborers had no lien on the Government property under construction, as the contractor and not the surety had completed performance under the contract, and as the materialmen and the laborers never had any right to the fund. In rejecting these contentions the Supreme Court held, 208 U. S. at page 410:

> "It [the surety] paid the laborers and material-men and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and supply men were paid. It did this not as a volunteer but by reason of contract obligations entered into before the commencement of the work."

This would seem to be plain enough. But *Henningsen* was commented upon in *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 6 Cir., 1921, 271 Fed. 144, and the priority of materialmen and laborers spelled out in no uncertain terms, at pp. 148-9:

> "In that case [Henningsen], the surety upon a bond of this kind [a payment bond], given pursuant to the 1894 statute, and who had been compelled to pay its surety obligation, was held entitled to priority in the retained fund as against a general creditor of the contractor. * * * The surety's claim of priority in the fund was sustained, and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated."

The Miller Act

It is common knowledge that difficulties and inconveniences arose in the application of the Heard Act. For example, the unpaid materialmen and laborers had to wait until six months after the completion and final settlement of the contract before they could proceed against the surety. If the Government instituted suit earlier, the laborers and materialmen could intervene, but shared only in the balance, if any, of the surety's liability remaining after the amount due the Government was paid in full. The legislative history of the Miller Act indicates clearly that the separate performance and payment bonds in their present form were substituted for the old law for the further

protection of materialmen and laborers. See 79 Cong. Rec. 11702 (1935) (remarks of Representative Miller); 79 Cong. Rec. 13382 (1935) (remarks of Senators Burke, Walsh and McCarran). There is nothing to indicate that the priorities of the materialmen and laborers were intended to be eliminated, or affected in any way by the new provisions of the Miller Act. Under the Heard Act, and under the Miller Act as well, the security for the materialmen and laborers was to stand in place of a lien on the property under construction, as no lien attaches to Government property. The purpose under each of these Acts was the same, to encourage laborers and those furnishing materials to undertake the construction of the Government facility, and to make sure that those who did so and created the product under construction should be secured out of the job itself rather than on the general credit of the prime contractor.

It follows we think that the same priorities held to exist under the Heard Act continue to exist under the Miller Act. If the Government was under "equitable obligations to see that the laborers and supply men were paid" (208 U. S. at page 410), this would seem sufficient to support the claim of the surety for priority, and such "equitable obligations" surely are not less under the Miller Act than they were under the Heard Act. In this context we think it quite immaterial that, after the termination of the contract, the little that remained to be done to complete the job was not done by the surety.

United States v. Munsey, 1947, 332 U. S. 234.

The decisions of the 9th and 10th Circuits in *Phoenix* and *Hinds* above referred to are based squarely on the premise that the Supreme Court in *Munsey* had sustained the Government's claim to a set-off partly because of "the weak-

ness of the surety's claim to equitable rights in the fund." See *Hinds,* 260 F. 2d at page 368. Perhaps this impression stems from the following dictum in *Munsey,* 332 U. S. at page 242:

> "We need not decide whether laborers and materialmen would have any claim to the retained percentages if both contractor and surety failed to pay them. Even if they do, certainly those would be rights to which the surety could not be subrogated, for by hypothesis it would have done nothing to earn subrogation."

In any event, we think the quotations from *Munsey* in the opinions in *Phoenix* and *Hinds* have been misconstrued. If the Supreme Court intended to make any comment with respect to the situation now before us, it was merely to say they held the point open for decision in the future. Of course, if the surety failed to pay materialmen and laborers, the surety "would have done nothing to earn subrogation." Moreover, the fact that "laborers and materialmen have no enforceable rights against the United States," 260 F. 2d at page 368, is beside the point. The question is not whether the laborers and materialmen have rights enforceable against the Government, but whether they have an equitable priority in the retained payments.

In *National Surety Corporation v. United States,* Ct. Claims, 1955, 133 F. Supp. 381, cert. denied *sub nom. First National Bank in Houston v. United States,* 1955, 350 U. S. 902, the Court said at page 384:

> "[T]he laborers and materialmen have the equitable right to assert a claim to moneys in the hands of the defendant [the United States] which are due to contractor. When the surety pays the laborers and materialmen, it becomes subrogated to their right to assert an equitable claim to the moneys in the hands of the

defendant. It has frequently been held that they have equitable priority to these moneys over the general creditors of the contractor and over his assignees. [Numerous citations omitted.]

* * *

In *United States v. Munsey Trust Co., supra*, the Supreme Court said that the United States was not legally liable to laborers and materialmen, but it did not say that laborers and materialmen could not assert an equitable claim to moneys in the hands of the United States payable under the contract. We think they can. To permit them to do so in no way interferes with the full exercise of the sovereign powers of the United States. It does not subject the defendant to liability beyond the amount it has in its hands confessedly due and owing to somebody."

Royal Indemnity Co. v. United States, Ct. Claims, 1950, 93 F. Supp. 891, is to the same effect.

The principle established by *Munsey* was that the Government's right to a set-off based on sums due from the contractor on other jobs was superior to any claim of the surety by way of subrogation. Furthermore, there is language in *Munsey* that justifies, if not compels, it to be limited to situations in which the United States is asserting a claim of its own to the retained funds. There are cases that have so held. *E. g. Royal Indemnity Co. v. United States, supra; United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 1947, 297 N. Y. 31; and cases cited in *Hinds*, 260 F. 2d at 368.

It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and subrogation that, as we have already pointed out, were so well established under the Heard Act. Certainly, there is

not the slightest intimation that anything in the Miller Act was intended to change priorities existing under the prior legislation. See *United States v. Aetna Casualty & Surety Co.*, 2 Cir., decided January 11, 1962, Slip Sheet, at page 622. Accordingly, we disagree with *Phoenix* and *Hinds*.

We hold the surety entitled to the fund by subrogation; and the order appealed from is affirmed.

No. [redacted] 78

IN THE

Supreme Court of the United States

October Term 1961

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

RESPONDENT'S BRIEF IN OPPOSITION TO A WRIT OF CERTIORARI TO REVIEW AN ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AFFIRMING AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NEW YORK

MARK N. TURNER,
Attorney for Respondent,
Reliance Insurance Company,
~~440 M~~ & T Building,
Buffalo 2, New York.

BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

INDEX.

TABLE OF CASES CITED.

IN THE

Supreme Court of the United States

October Term 1961

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

BRIEF ON BEHALF OF RESPONDENT RELIANCE INSURANCE COMPANY IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

Statement

The petitioner seeks a writ of certiorari on the ground that the United States Court of Appeals for the Second Circuit has misconstrued the decision of this Court in *United States v. Munsey Trust Co.*, 332 U. S. 234, 67 S. Ct. 1599, decided in May 1947.

The Question Involved

The matter in issue is whether a surety who has paid *all* of its bankrupt contractor-principal's unpaid labor and material bills on a federal job, is entitled to the contract balance ahead of the bankrupt contractor's Trustee in Bankruptcy.

The interests of the United States are in no way involved.

The funds in question represent the fruit of labor and materials furnished and supplied to the Corps of Engineers, relating to a St. Lawrence Seaway job, prior to the bankruptcy of the contractor. There are no unpaid job creditors on the contract out of which the funds in question arose, as the surety has paid all of them. The funds were paid to the Trustee in Bankruptcy under a tacit agreement between the trustee and the surety in the interest of an orderly determination of the question here involved.

POINT I

This Court has clearly indicated the scope and limits of its determination in United States v. Munsey Trust Co., 332 U. S. 234, 67 S. Ct. 1599 (1947), and accordingly the granting of a writ of certiorari is not necessary.

By a long line of decisions starting with *Prairie State National Bank v. U. S.,* 164 U. S. 227 in 1896 this Court has recognized the distinctive and equitable rights of a surety who has completed its defaulted principal's contract to receive the remaining unpaid contract moneys.

Later in 1908 this Court in *Henningsen v. U. S. F. & G. Co.,* 208 U. S. 404, 28 S. Ct. 389, likewise recognized the surety's same distinctive and equitable rights to the unpaid contract moneys where the surety, pursuant to its obligation or bond, paid the contractor's unpaid bills for the labor and material which went into the improvement, and which labor and material "produced" the contract moneys in question.

In 1921 the Sixth Circuit, in *Belknap Hardware Co. v. Ohio River Co.*, 271 Fed. 144, commented at some length on the surety's right of subrogation recognized by this Court in the *Henningsen* case (*supra*).

In none of those cases were the rights of the United States involved. In the intervening years there was little or no variation in the decisions of the Courts as to the surety's paramount rights under either a performance bond, such as was involved in the *Prairie State Bank* case (*supra*), or under a labor and materials or payment bond, such as was involved in the *Henningsen* case (*supra*). And this was true whether the surety's contestant was an assignee bank or the contractor's Trustee in Bankruptcy.

In *United States vs. Munsey Trust Co.*, 332 U. S. 234, 67 S. Ct. 1599, this Court in 1947 had a situation where the United States was more than a stakeholder of the contract funds. The contractor owed the Government money on one unbonded contract and, at the same time, the Government owed the same contractor money on other contracts which the surety bonded. The contractor's surety on the bonded contracts sought the total contract balance on the bonded contracts on which it had paid labor and material bills. The Government asserted its right of set-off.

This Court permitted the Government to enjoy its set-off for its claims on the unbonded contract out of the contract moneys on the bonded jobs, but very clearly limited the scope of its holding to set-off situations.

In unmistakable language this Court, at page 240, wrote:

> "From *Prairie State Nat. Bank of Chicago v. United States*, 164 U. S. 227, 17 S. Ct. 142, 41 L. Ed. 412, to *American Surety Co. v. Sampsell*, 327 U. S. 269, 66 S. Ct. 571, 90 L. Ed. 663, *we have recognized the*

peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available moneys ahead of others whose claims come from the advance of money. But in all those cases, the owner was a mere stakeholder and had no rights of its own to assert." (Emphasis ours.)

The petitioner has assumed or conceded that, had the respondent paid losses under the performance bond, it would be entitled to the fund here in question.

In this connection, it is significant that while the surety involved in the *Munsey Trust* case had paid bills under its payment bond, this Court, in the quotation set forth above, cited both the *Prairie State National Bank* case, decided in 1896, which involved a *performance bond*, and also the *American Surety Co. v. Sampsell* case, decided in 1946, a year before the *Munsey Trust* case, which involved a *payment bond.* And, of course, included within the time span of those two decisions, was the *Henningsen* case (*supra*) which also involved a payment bond.

In other words, it would appear quite clear that this Court recognized the peculiar and distinctive equities of a surety under *both a performance* and a *payment bond.*

In 1955, the Court of Claims, in *National Surety Corp. v. U. S.,* 133 Fed. Supp. 381, had before it a contest between a surety on a payment bond on a Government contract, and an assignee bank of contract moneys in the hands of the Government, which was a mere stakeholder.

In awarding the fund to the surety, the Court of Claims wrote at page 383:

"We reiterate our former opinion that the equity of the surety company is superior to the rights of the bank acquired under an assignment, *whether the surety's rights are derived from the discharge of its liability on a performance bond or on a payment bond.*

In *Prairie State Nat. Bank, supra*, the surety had discharged its liability on a performance bond, and in *Henningsen, supra*, its liability on a payment bond." (Emphasis ours.)

In November of 1955, this Court denied a petition for a writ of certiorari in this case *sub. nom. First National Bank in Houston v. U. S.*, 350 U. S. 902, 76 S. Ct. 181.

Thus, we respectfully submit, this Court, since its decision in the *Munsey Trust* case, has not been inclined to disturb the decision of at least one Court which, 1) refused to draw any distinction between a surety who has sustained losses under a *performance bond* on the one hand, and a surety who has sustained losses under a *payment bond*, and 2) which sustained the paramount right of the surety to the contract balances.

Accordingly, we respectfully submit that the present case does not call for any further review by this Court.

POINT II

The petition for a writ of certiorari should be denied.

We respectfully submit that the decision of the Second Circuit Court of Appeals in the instant case is in conformity with the decision of this Court in the *Munsey* case (*supra*), and that the petition for a writ of certiorari to review the decision of said Second Circuit Court of Appeals should be denied.

Respectfully submitted,

MARK N. TURNER,
Attorney for Respondent,
Reliance Insurance Company,
440 M & T Building,
Buffalo 2, New York.

No. [redacted] 78

IN THE

Supreme Court of the United States

October Term—1962

In the Matter

of

DUTCHER CONSTRUCTION CORPORATION,

Bankrupt.

MOTION FOR LEAVE TO FILE AN AMICUS CURIAE BRIEF

JOHN G. STREET, JR.
Applicant
625 Fort Worth National Bank Bldg.
Fort Worth, Texas

IN THE

Supreme Court of the United States

October Term—1961

In the Matter

of

DUTCHER CONSTRUCTION CORPORATION,

Bankrupt.

MOTION FOR LEAVE TO FILE AN AMICUS CURIAE BRIEF

TO THE HONORABLE SUPREME COURT OF THE UNITED STATES:

Consent to the filing of an *amicus curiae* brief by your applicant, John G. Street, Jr., having been refused by appellee, applicant respectfully files this motion for leave to file an *amicus curiae* brief herein.

THE NATURE OF APPLICANT'S INTEREST

Applicant is the attorney for Burton B. Paddock, Trustee in Bankruptcy for Stanford Construction Company, which was adjudicated a bankrupt in Cause No. 2439 in bankruptcy, in the United States District Court for the Northern District of Texas, Fort Worth Division. Trustee Paddock took over and completed two of his Bankrupt's contracts; the Bankrupt's bonding company, New Amsterdam Casualty Company, after the adjudication of bankruptcy made payments under the payment bond to unpaid laborers and materialmen. Hon. John Ford, Referee in Bankruptcy, held that the bonding company did not have a preferred claim to the retainages and payments due under the two contracts but should share in the proceeds with the other general creditors. The bonding company's petition for review is now pending in the United States District Court for the Northern District of Texas, Fort Worth Division. When the case at bar was before the Second Circuit, applicant filed, with the permission of that Court, an *amicus curiae* brief. This Court's decision will have an important bearing on the ultimate decision of the case involving applicant's client. Applicant is vitally interested in the Court being as fully informed as possible in regard to the law involved.

REASONS WHY APPLICANT SHOULD BE ALLOWED TO FILE AN AMICUS CURIAE BRIEF

Trustee Paddock, applicant's client, completed the two jobs which are involved in his controversy with the bonding company, and the bonding company did not do anything under its performance bond.

Your applicant believes that if he is allowed to file an *amicus curiae* brief the question of law will be more adequately presented regarding the difference between a bonding company's rights when a performance bond is involved and when a payment bond is involved. This is relevant to the disposition of this case as a payment bond is involved in this case. Since the Trustee in the case at bar did not complete the contract in question, applicant does not believe that the parties will adequately present to the Court the effect that the Court's decision would have on the situation where the Trustee completed the job, as applicant's Trustee did. This is relevant to the case at bar for a holding herein that a bonding company which makes payments under its payment bond but which does not complete the job is superior to a general creditor of the bankrupt contractor would lead to the anomalous result that when a bonding company takes over and

completes a job it is entitled to all retainages but when the Trustee does the same thing he is not so entitled.

WHEREFORE, applicant prays that he be granted permission to file an *amicus curiae* brief herein.

John G. Street Jr

JOHN G. STREET, JR.,
Applicant

I hereby certify that I have served a copy of the foregoing motion on Honorable Raymond T. Miles, 942 Ellicott Square Building, Buffalo 3, New York, Appellant's counsel of record, and Honorable Mark N. Turner, 440 M & T Building, Main and Swan Streets, Buffalo 2, New York, Appellee's counsel of record, by depositing on May 26, 1962, a copy of same in a United States mail box with air mail postage prepaid, addressed to each of the above named counsel of record at the post office address set forth above.

John G. Street Jr

JOHN G. STREET, JR.,
Applicant

No. 78

MOTION FILED JUN 25 1962

In The

Supreme Court of the United States

October Term - 1961

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

MOTION FOR LEAVE TO FILE AN AMICUS CURIAE BRIEF

EDWARD M. MURPHY
*Attorney for Paulus F. McKee,
Trustee in Bankruptcy of
Funderburk Construction
Corp. No. B47910,*
420 S.E. Jackson Street,
Roseburg, Oregon

In The

Supreme Court of the United States

October Term - 1961

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

MOTION FOR LEAVE TO FILE AN AMICUS CURIAE BRIEF

TO THE HONORABLE SUPREME COURT OF THE UNITED STATES:

Consent to the filing of an amicus curiae brief by your applicant, Edward M. Murphy, having been refused by appellee, applicant respectfully files this motion for leave to file an amicus curiae brief herein.

The Nature Of Applicant's Interest

Applicant is attorney for Paulus F. McKee, Trustee in Bankruptcy for Funderburk Construction Corporation a road construction contractor, which was adjudicated a bankrupt in Cause No. B47910 in the United States District Court for Oregon. The Trustee with the Court's approval employed a road contractor who completed a government road project which was uncompleted at the time of bankruptcy. The bankrupt's bonding company, Federal Insurance Company, made payments in the amount of $37,931.35 to various materialmen and laborers on the road project and the bonding company has asserted a claim before the Honorable Lester Oehler, Referee in Bankruptcy, to all of the proceeds due the Trustee from the completion of this project. A hearing has been held on this claim but no decision has been rendered by the Referee.

Part of these funds to which the bonding company lays claim are still in the possession of the United States government and part of the funds are in the possession of the applicant. In addition the bonding company is claiming to be

the owner of a cause of action for breach of contract which the bankrupt had against a subcontractor on the road project.

Reason Why Applicant Should Be Allowed To File An Amicus Curiae Brief

Your applicant by completing the Yellowstone Road Project created in part the funds now being held by the United States government and to which the bankrupt's surety has laid claim. The reason for requesting opportunity to file an amicus curiae brief is to show the effect that a decision favorable to the surety would have in a case where the Trustee completed the bankrupt's government construction project. Monies retained by the government on a government construction project have been considered as security to assure the completion of the project. If leave is granted to us to file an amicus curiae brief, we wish to show that a decision in favor of the surety company in this case would have the effect of depriving the applicant of the benefit of these retained funds in the event he completes the project but permitting the surety to receive these funds in the event the surety completes the project.

WHEREFORE, applicant prays that he be granted permission to file an amicus curiae brief herein.

Edward M. Murphy

EDWARD M. MURPHY
Applicant

I hereby certify that I have served a copy of the foregoing motion on Honorable Raymond T. Miles, 942 Ellicott Square Building, Buffalo 3, New York, Appellant's counsel of record, and Honorable Mark N. Turner, 440 M & T Building, Main and Swan Streets, Buffalo 2, New York, Appellee's counsel of record, by depositing on June 19, 1962, a copy of same in a United States mail box with air mail postage prepaid, addressed to each of the above named counsel of record at the post office address set forth above.

Edward M. Murphy

EDWARD M. MURPHY
Applicant

IN THE

Supreme Court of the United States

OCTOBER TERM. 1962

No. 78

CHESTER A. PEARLMAN, TRUSTEE,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY.

MOTION FOR LEAVE TO FILE AN AMICUS CURIAE BRIEF

DAVID MORGULAS,
Applicant,
521 Fifth Avenue,
New York City, New York.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 78

CHESTER A. PEARLMAN, TRUSTEE,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY.

MOTION FOR LEAVE TO FILE AN AMICUS CURIAE BRIEF

To the Honorable Supreme Court of the United States:

Consent to the filing of an Amicus Curiae Brief by your Applicant, DAVID MORGULAS, having been refused by Appellant, Applicant respectfully files this motion for leave to file an Amicus Curiae Brief herein.

The Nature of Applicant's Interest

Applicant has been retained by the Association of Casualty and Surety Companies, a non profit trade association consisting of one hundred thirty-six capital stock companies, most of which write fidelity and surety bonds in almost every State, and in connection with public works contracts and other surety bond requirements of the United States of America. The member companies of the Association write at least eighty-five percent of the annual premium volume of surety bonds written throughout the United States.

A decision against the surety by this Court in this case will have a profound bearing upon the long standing underwriting concepts and practices of the Association's member companies and as a necessary consequence, on the number of bidders qualified by them on Federal Public Works contracts.

Reasons Why Applicant Should Be Allowed to File an Amicus Curiae Brief

Your Applicant believes that if he is allowed to file an Amicus Curiae Brief, the economic and historical genesis of the sureties' rights and the exact nature of these rights will be more fully presented. Inasmuch as the rights which a surety has historically enjoyed stem from its relationship to the formal parties to Public Works contracts and to labor and material suppliers, your Applicant feels that it would be most advantageous if the Court had before it a full analysis of the workings of the construction industry, the creation and nature of the fund sought by both parties in the instant case, and particularly the effects which the position taken by the Ninth Circuit, if supported by this Court, would have upon the surety industry, the construction industry and the costs of Federal Public Works construction.

If sureties are deprived of their long recognized rights of salvage or reimbursement vis-a-vis general creditors of a bankrupt contractor (represented by a Trustee in Bankruptcy) there is a likelihood that present premium rates for surety bonds on Federal Public Works contracts will prove to be inadequate and will have to be revised, thereby increasing the cost of such public works construction to the United States. Furthermore, a general tightening up of

underwriting procedures will be necessitated with the result that many potential bidders on United States Public Works projects will be unable to qualify for suretyship, thereby diminishing the number of available bidders with a consequent increase in bid prices. This narrowing of the base of bidders will run counter to the policy of Congress as implemented by the Small Business Administration to increase the number of potential bidders on Government contracts by encouraging awards thereof to "small business".

WHEREFORE, Appellant prays that he be granted permission to file an Amicus Curiae Brief herein.

DAVID MORGULAS
David Morgulas
Applicant

M. CARL LEVINE, MORGULAS & FOREMAN
521 Fifth Avenue
New York 17, New York
Of Counsel

I hereby certify that I have served a copy of the foregoing motion on Honorable Raymond T. Miles, 942 Ellicott Square Building, Buffalo 3, New York, Appellant's counsel of record, and Honorable Mark N. Turner, 440 M & T Building, Main and Swan Streets, Buffalo 2, New York, Appellee's counsel of record, by depositing on July 20, 1962, a copy of same in a United States mail box with air mail postage prepaid, addressed to each of the above named counsel of record at the post office address set forth above.

DAVID MORGULAS
David Morgulas
Applicant

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner,

vs.

RELIANCE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

RAYMOND T. MILES,
LOWELL GROSSE,
Attorneys for Chester A. Pearlman, Trustee-in-Bankruptcy of Dutcher Construction Corporation,
942 Ellicott Square Building,
Buffalo 3, New York.

BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the United States District Court for the Western District of New York is reported in 197 Fed. Supp. 441. The opinion of the United States Court of Appeals for the Second Circuit is reported in 298 Fed. 2nd, 655. The opinion of the referee in bankruptcy was published in Volume 35, No. 3 of the Journal of the National Association of Referees in Bankruptcy.

Jurisdiction

The jurisdiction of this court is invoked because this is a matter involving a bankrupt corporation and its creditors and the decision herein of the United States Court of Appeals for the Second Circuit is in conflict with the applicable decisions of the United States Court of Appeals for the Ninth Circuit and the United States Court of Appeals for the Tenth Circuit. The United States Court of Appeals for the Second Circuit has further decided a federal question in a way which is in conflict with the applicable decision of this court. The petition for a writ of certiorari was filed on March 5, 1962, and granted on April 16, 1962.

Statute Involved

This case involves the Miller Act, 40 U. S. C. A., Secs. 270A-270D. (Set forth in appendix.)

Question Presented

The question presented for review is whether the Reliance Insurance Company, which paid certain laborers and materialmen for services and materials furnished to the Dutcher Construction Corporation prior to that corporation's bankruptcy, is entitled to be paid prior to general creditors of the bankrupt Dutcher Construction Corporation, the monies earned by Dutcher Construction Corporation prior to its bankruptcy and paid over by the United States of America subsequent to said bankruptcy, to the Trustee in Bankruptcy, of Dutcher Construction Corporation.

Statement of Facts

The facts material to a consideration of the question presented are as follows:

The bankrupt, Dutcher Construction Corporation, executed a contract with the United States Corps of Engineers for certain construction on the St. Lawrence Seaway and furnished to the Corps payment and performance bonds; both issued by the Fire Association of Philadelphia, now named the Reliance Insurance Company. This was done on or about April 11, 1955, and was pursuant to the Miller Act, 40 U. S. C. A., Secs. 270A-270D.

The bankrupt entered into performance of its contract with the Corps of Engineers and incurred bills for labor and materials which were covered by the payment bond issued by the surety company. The bankrupt never defaulted in the performance of the contract so far as the Corps of Engineers was concerned, but the contract between the bankrupt and the Corps was terminated on April 11, 1956, for the convenience of the Corps and with the consent of the bankrupt.

When the contract was terminated, the bankrupt had completed a very substantial part of the contract but it had run out of money and left approximately $326,248.42 of unpaid bills covered by the payment bond. These the surety proceeded to pay pursuant to the terms of the payment bond. The surety further claims that it has expenses in connection with said payments of $20,754.34 and other payments of $22,924.99. The bills were paid by the surety in the spring and summer of 1956, and at the end of August, 1956, Dutcher Construction Corporation was adjudicated a bankrupt.

Subsequent to the termination of the contract with the Corps of Engineers; the Corps, with the consent of the bankrupt corporation, awarded the unfinished portion of the Dutcher contract to a joint venture of several corporations which agreed with the United States Corps of Engineers to complete the same at the Dutcher Construction Corporation prime contract price.

The joint venturers also agreed that they would do certain of the work which had been left unfinished by the bankrupt corporation for the sum of $40,000.00; said $40,000.00 to be a charge against the sum of $127,737.35 earned by the bankrupt and retained by the Corps of Engineers at the time of the termination of the bankrupt's contract.

Neither the Trustee nor the surety objected to this sum being taken from the Dutcher prime contract monies and, in fact, they agreed that this was a fair price to pay the joint venturers for the completion of the contract which should have been done by the bankrupt corporation. The joint venturers did complete their work and were paid $40,000.00, leaving a balance retained by the United States in the sum of $87,737.35. This sum was thereafter paid to the Trustee.

It is this sum of $87,737.35 to which the surety company asserts it has a right which is prior to the rights of the general creditors of the bankrupt corporation.

Summary of Argument

The Trustee in Bankruptcy's opposition to the application of the surety company is based on the fact that the surety company has paid materialmen and laborers who can assert no lien or priority against the funds in the

possession of the United States to the detriment of the general unsecured creditors. Consequently the surety company cannot by subrogation to the rights of the laborers and materialmen become entitled to assert a lien or priority against the same funds.

The Trustee further argues that there is a logical distinction between a surety company which has performed and thereby created a fund due from the United States for such performance and a surety which has paid laborers and materialmen and has not thereby created a fund due from the federal government. In the former case the creator of the fund should be rewarded for its efforts. In the latter case no reward is merited.

Argument

The petitioner relies principally on the following three cases:

1. *United States v. Munsey Trust Co.*, (1947), 332 U. S. 234, 91 L. Ed. 2022.
2. *American Surety Co. v. Oscar Hinds, Trustee* (C. A. 10), 1958, 260 Fed. 2d. 366.
3. *Phoenix Indemnity Co. v. Hugh A. Earle* (C. A. 9), 1955, 218, Fed. 2d. 645.

The petitioner-Trustee in Bankruptcy takes the position that the Reliance Insurance Company, which paid materialmen and laborers under its payment bond but which did not complete the bankrupt's job with the Corps of Engineers, is not entitled to a priority against the funds earned by the bankrupt prior to its bankruptcy and retained by the Corps of Engineers and subsequently paid over to the Trustee in bankruptcy.

The respondent Reliance Insurance Company, however, takes the position that it is entitled to the funds in question prior to the general creditors of the bankrupt whether it paid laborers and materialmen of the bankrupt pursuant to its payment bond or performed under the performance bond.

Basically, therefore, the Trustee claims there is no right of priority to the fund on the part of the Reliance Insurance Company because of payment under its payment bond. The Trustee concedes that there might be such a right of priority if the insurance company had performed under its performance bond thereby creating the fund retained by the federal government.

In the *Munsey* case, *supra*, a surety had written bonds for a government contractor on several jobs. These jobs were completed although the contractor left a number of laborers and materialmen unpaid. The surety paid these laborers and materialmen.

This same contractor had another contract with the federal government but no bonds had been furnished to the government by the contractor on this job which was not performed by the contractor. The government perforce secured another contractor to do the job but at a higher cost. Accordingly, the government was damaged to the extent of the increased cost of the unbonded job.

This court permitted the federal government to set off against the unpaid contract balances on the bonded jobs, *i.e.* the retainages, the excess cost to the government on the unbonded job.

This was a new problem for this court for, as Justice Jackson said at page 236:

"This case presents a problem arising out of contracts for public building construction and repair. The rights *inter sese* of contractor, surety, assignees and government have been productive of much litigation, but we have not heretofore had to decide whether percentages retained pursuant to contract by the United States may be subjected to its set-off claims despite the claims of a surety who has paid laborers and materialmen."

Consequently, the petitioner's position here is that we need look only so far as the *Munsey* case and the later opinions interpreting the *Munsey* decision.

That decision goes right to the problem here when Justice Jackson wrote, at page 240:

"But the surety urges that it is subrogated also to the rights of laborers and materialmen whom it paid and of the United States. From Prairie State Nat. Bank v. United States, 164 U. S. 227, 41 L. ed. 412, 17 S. Ct. 142, to American Surety Co. v. Sampsell, 327 U. S. 269, 90 L. ed. 663, 66 S. Ct. 571, we have recognized the peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available moneys ahead of others whose claims come from the advance of money. But in all those cases, the owner was a mere stakeholder and had no rights of its own to assert. Respondent tells us that here the United States is in the same position and that as a general creditor, it has no more right to the money which it holds than does any other general creditor of the contractor."

However, with this full awareness of the surety's position this court held against it, stating at page 242 that:

"In relying on the rights of the laborers and materialmen, however, the surety must establish that those rights existed before their claims were paid. For it is elementary that one cannot acquire by subrogation what another whose rights he claims, did not have. Once the laborers and materialmen have been paid, either by contractor or surety, they have

no rights in any fund. If before they are paid, the fund to which they are said to be entitled to look is unavailable for the very reason that they are unpaid, the surety relies on nothing when it relies on those non-existent 'rights'."

It would seem futile to refer to all the cases cited by the surety company in its briefs below. However, two of them were given great emphasis and will be briefly referred to.

In the brief and argument submitted to the United States Court of Appeals, Second Circuit, the respondent made much of the case of *Henningson v. U. S. F. & G. Co.* (1908), 208 U. S. 404, 28 Sup. Ct. 389. Respondent referred to the fact that this case was not mentioned in the *Munsey* case opinion and therefore reasoned that the principle of the *Munsey* case should be confined to its own facts, *i.e.* where the government was a party. The *Henningson* case, however, was cited to the court in the brief of the surety upon argument of the *Munsey* case.

Moreover, the *Henningson* case is far afield. It involved a contest between a surety who had paid under a payment bond and an assignee bank to whom the contractor had assigned his rights to the contract moneys in return for a loan of money to be used by the contractor on the job or not, as he saw fit.

The court distinguished the positions of the surety and the bank. The former became subrogated, it said, because it paid pursuant to contract; the bank, it was said, was a mere volunteer.

This is not our situation. The Trustee here represents all creditors. Some of them became creditors before the federal contract was executed and performance and payment bonds were issued.

Moreover, the surety can adjust its premiums. It is engaged in risk taking and was paid a large premium. The creditors cannot do this.

The surety has also given its approval to *Prairie State National Bank v. U. S.*, 164 U. S. 227 (1896). So has the petitioner for it is a performance bond case. There a contractor's surety *completed* the contractor's job and prevailed over a bank which was an assignee of the contractor. The *Prairie State* case was cited to this court in the *Munsey* briefs and mentioned in the *Munsey* opinion.

The cases which have followed and interpreted the *Munsey* case completely support the petitioner.

The *Hinds* case, *supra*, is on all fours with this one. Judge Medina at the time of the argument in the Circuit Court stated that if this case *i.e.* the *Hinds* case, is correct, the petitioner here must prevail.

In the *Hinds* case, the surety company on a payment bond furnished to the United States by the Bankrupt, as required under the Miller Act, sought an order requiring the Trustee in Bankruptcy to turn over to it monies received by the Trustee from the United States for work done by the Bankrupt and the Trustee who had completed the contract in question. The application was denied by the lower court and the United States Circuit Court of Appeals, 10th Circuit, affirmed the denial.

The court held that the surety, merely by reason of the payment of labor and material bills incurred by a contractor prior to its adjudication as a bankrupt and in accordance with its own obligation under its payment bond, did not acquire any right to net contract funds superior to the right of the Trustee representing the general creditors.

The court said, at page 368 of the opinion,

"The rights of a surety are largely derivative in nature. Having paid the laborers and materialmen, appellant may claim subrogation to their rights. But since laborers and materialmen have no enforceable rights against the United States (*U. S. v. Munsey Trust Co.*, 332 U. S., page 241), the surety can rise no higher than the basis of the subrogation. The very purpose of the payment bond required under the Miller Act, is to shift the ultimate risk of non-payment from the workmen and the suppliers to the surety."

The court in the *Hinds* case also said, at footnote 5, on page 368:

"We are not required to consider whether a different rule might be applicable were a claim made under a performance bond."

The court did note a number of cases which would be favorable to the position of the surety company here and stated the facts of those cases were indistinguishable in substance from the facts of the *Hinds* case. Nevertheless, the court stated, again at page 368:

"We are not convinced, however, of the merit of reasoning which limits the clear holding of *Munsey* to factual situations where the government is a direct claimant. Mr. Justice Jackson, speaking for the court, notes that the claim of the surety must fail for *two* reasons, both the strength of the government's right to set-off and the weakness of the surety's claim to equitable rights in the fund. The reasoning of the opinion in the latter regard is in no way dependent upon the United States being a claimant."

The court also went on to say, at page 368:

"The very purpose of the payment bond required under the Miller Act is to shift the ultimate risk of nonpayment from workmen and suppliers to the surety. The United States does not retain funds for that purpose for it is said:

> 'But although we have assumed, for the purposes of another argument, that assurance that laborers and materialmen will be paid is one of the reasons for retaining the money, it seems more likely that completion of the work on time is the only motive. (Citations) It is hardly reasonable to withhold money in order to assure payments which perhaps can be made only from the money earned. In any event, we are not prepared to apply law relating to security to unappropriated sums which exist only as a claim.' *United States v. Munsey Trust Co.*, 332 U. S., at page 243, 67 S. Ct. at page 1603."

The appellant also relies on *Phoenix Indemnity Co. v. Earle, supra.* This case was decided in the Ninth Circuit eight years after the *Munsey* case.

In that case a contractor went bankrupt. The United States had asserted certain tax liens against the assets of the bankrupt in the hands of the trustee. The referee in bankruptcy held that the funds received by the trustee from the Bonneville Power Administration came into the hands of the trustee impressed with the tax liens and that the sum of the liens should be paid to the Director of Internal Revenue. The surety company appealed and the District Court affirmed. The surety again appealed to the Circuit Court.

The basic question was whether the government tax liens asserted against the funds in the hands of the trustee in bankruptcy were superior to the claim of the surety company.

The surety company had complied with the Miller Act, furnishing both payment and performance bonds.

The contractor did not default in performance. (Neither did Dutcher Construction Corporation default in its contract with the Corps of Engineers). However, the surety

company did pay materialmen and laborers pursuant to its payment bond.

The surety company asserted a right to the funds held by the trustee on the basis of subrogation. However, the court said at page 648:

> "In its brief the appellant based its right of subrogation upon its payments to labor and materialmen. In oral argument appellant expressly abandoned any claim of subrogation based upon materialmen's claims and appears to have no further claim of subrogation other than a passing remark in oral argument, that although it abandoned its rights to be subrogated to materialmen it did not give up any right to be subrogated to the rights of the Government. No prior nor further reference was made to such a right of subrogation to the Government's position, nor was any explanation or authority offered for such a claim during oral argument or in the brief.
>
> (1, 2) Such an assertion would seem to have been laid to rest in *United States v. Munsey Trust Co., supra,* from which the Referee quoted extensively in his 'Discussion of Law' in 'Referee's Findings, Opinion and Order' which were adopted in their entirety by the district court. After Justice Jackson established in the Munsey case that the United States was a secured creditor he said at page 241 of 332 U. S., at page 1602 of 67 S. Ct.:
>
> 'But the infirmity in respondent's case goes deeper. If the United States were obligated to pay laborers and materialmen unpaid by a contractor, the surety who discharged that obligation could claim subrogation. But nothing is more clear than that laborers and materialmen do not have enforceable rights against the United States for their compensation. (Citations.) They cannot acquire a lien on public buildings, (citations) and as a substitute for that more customary protection, the various statutes were passed which require that a surety guarantee their payment. Of these, the last and the one now in force is the Miller Act [40 U. S. C. A. §270a *et seq.*] under which the bonds here were drawn.'"

Consequently, the appellant's position is sustained completely by these two authorities which the Second Circuit Court has chosen not to follow. Indeed, the Second Circuit seemingly had some doubt on its own position and the meaning of the *Munsey* case for after stating that the *Hinds* and *Phoenix* cases had miscontrued the *Munsey* case, the opinion stated at page 658:

> "If the Supreme Court intended to make any comment with respect to the situation now before us, it was merely to say they held. the point open for decision in the future."

But can it be said that this court has left the point open? Certainly the Ninth and Tenth Circuit Courts have not, as the Second Circuit Court readily admits. Those circuit courts had no doubt that the question was decided in the *Munsey* decision.

Moreover, in *Massachusetts Bonding & Insurance Co. v. State of New York* (1958) 259 Fed. 33, the United States Court of Appeals for the Second Circuit had to consider the conflicting rights of a surety, a bankrupt corporation and the United States. This case was also a Miller Act case and the surety contended that it was entitled to be subrogated to the position of the United States in relation to the latter's liens for taxes with interest and penalties which were satisfied prior to bankruptcy by set-off against money earned by the bankrupt on a job for the United States. The Second Circuit Court said at page 36:

> "But the surety cannot establish this fact, for under the doctrine of *United States v. Munsey Trust Co.* * * *, neither the bankrupt nor the surety ever became entitled to those funds, so that there was nothing for the surety to own. In short, the surety by way of subrogation might be entitled to progress payments and retained percentage, due its principal *if the surety completes the job after the principal's default.* (Citing numerous authorities)."

Consequently, we contend that the holding in the instant case is not even in accord with the previous decision of the United States Court of Appeals for the Second Circuit in *Massachusetts Bonding & Insurance Co., supra.*

However, if we are to return to basic reasoning rather than a citation of authority, what will be the decision of the court in the following assumed situation.

> A trustee in bankruptcy receives funds from the federal government for work done by the trustee on public construction, which funds were retained by the government during the course of the trustee's construction. Assume further that the bankrupt and its trustee never defaulted in performance. Assume, however, that the surety company on a payment bond furnished pursuant to the Miller Act paid materialmen and laborers for work done for the bankrupt prior to bankruptcy.

This is the situation presently before the District Court for the Northern District of Texas on appeal from a decision of the Referee in Bankruptcy of that court. That Referee in Bankruptcy was aware of the history of this case up to and through the decision of the Second Circuit Court. In fact, the *Hinds*, *Phoenix* and *Dutcher* cases were cited to him. That Referee held, and logically we believe, that the surety could not assert a priority to the retainages over the general creditors of the bankrupt. That Referee saw the need of distinction between the surety who had performed and created a fund and a surety who has merely paid.

If that Referee had held otherwise, the Trustee who did the work would not have received the funds and the surety who did not do the work would have received the funds.

The only solution here is obviously a holding that he who performs, secures the fund. The surety here has not performed. It is engaged in risk business. It was paid handsomely for the risk and now should take its place with the general creditors.

CONCLUSION

For the reasons stated it is respectfully submitted that the order and judgment of the United States Court of Appeals for the Second Circuit should be reversed and the order of the Referee in Bankruptcy of June 9, 1961, be reinstated.

RAYMOND T. MILES,
Counsel for Petitioner.

July 24, 1962.

Appendix

§ 270a. Bonds of contractors for public buildings or works; waiver of bonds covering contract performed in foreign country.

(a) Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, which shall become binding upon the award of the contract to such person, who is hereinafter designated as "contractor":

(1) A performance bond with a surety or sureties satisfactory to the officer awarding such contract, and in such amount as he shall deem adequate, for the protection of the United States.

(2) A payment bond with a surety or sureties satisfactory to such officer for the protection of all persons supplying labor and material in the prosecution of the work provided for in said contract for the use of each such person. Whenever the total amount payable by the terms of the contract shall be not more than $1,000,000 the said payment bond shall be in a sum of one-half the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $1,000,000 and not more than $5,000,000, the said payment bond shall be in a sum of 40 percentum of the total amount payable by the terms of the contract. Whenever the total amount payable by the terms of the contract shall be more than $5,000,000 the said payment bond shall be in the sum of $2,500,000.

(b) The contracting officer in respect of any contract is authorized to waive the requirement of a performance bond and payment bond for so much of the work under such contract as is to be performed in a foreign country if he finds that it is impracticable for the contractor to furnish such bonds.

(c) Nothing in this section shall be construed to limit the authority of any contracting officer to require a performance bond or other security in addition to those, or in cases other than the cases specified in subsection (a) of this section. Aug. 24, 1935, c. 642, § 1, 49 Stat. 793.

§ 270b. Same; rights of persons furnishing labor or material.

(a) Every person who has furnished labor or material in the prosecution of the work provided for in such contract, in respect of which a payment bond is furnished under section 270a of this title and who has not been paid in full therefor before the expiration of a period of ninety days after the day on which the last of the labor was done or performed by him or material was furnished or supplied by him for which such claim is made, shall have the right to sue on such payment bond for the amount, or the balance thereof, unpaid at the time of institution of such suit and to prosecute said action to final execution and judgment for the sum or sums justly due him: *Provided, however,* That any person having direct contractual relationship with a subcontractor but no contractual relationship express or implied with the contractor furnishing said payment bond shall have a right of action upon the said payment bond upon giving written notice to said contractor within ninety days from the date on which such person did or performed the last of the labor or furnished

or supplied the last of the material for which such claim is made, stating with substantial accuracy the amount claimed and the name of the party to whom the material was furnished or supplied or for whom the labor was done or performed. Such notice shall be served by mailing the same by registered mail, postage prepaid, in an envelope addressed to the contractor at any place he maintains an office or conducts his business, or his residence, or in any manner in which the United States marshal of the district in which the public improvement is situated is authorized by law to serve summons.

(b) Every suit instituted under this section shall be brought in the name of the United States for the use of the person suing, in the United States District Court for any district in which the contract was to be performed and executed and not elsewhere, irrespective of the amount in controversy in such suit, but no such suit shall be commenced after the expiration of one year after the day on which the last of the labor was performed or material was supplied by him. The United States shall not be liable for the payment of any costs or expenses of any such suit. As amended Aug. 4, 1959, Pub. L. 86-135, § 1, 73 Stat. 279.

§ 270c. Same; right of person furnishing labor or material to copy of bond.

The Comptroller General is authorized and directed to furnish, to any person making application therefor who submits an affidavit that he has supplied labor or materials for such work and payment therefor has not been made or that he is being sued on any such bond, a certified copy of such bond and the contract for which it was given, which copy shall be *prima facie* evidence of the contents, execution, and delivery of the original. Applicants shall

pay for such certified copies such fees as the Comptroller General fixes to cover the cost of preparation thereof. As amended Aug. 4, 1959, Pub. L. 86-135, § 2, 73 Stat. 279.

§270d. Same; definition of "person" in sections 270a, 270b and 270c.

The term "person" and the masculine pronoun as used in sections 270a-270c of this title shall include all persons whether individuals, associations, copartnerships, or corporations. Aug. 24, 1935, 642, § 4, 49 Stat. 794.

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, TRUSTEE,
PETITIONER,

vs.

RELIANCE INSURANCE COMPANY,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE
JOHN G. STREET, JR.
IN SUPPORT OF PETITIONER

JOHN G. STREET, JR.
Amicus Curiae
625 Fort Worth National Bank Bldg.
Fort Worth, Texas

SUBJECT INDEX

INDEX OF AUTHORITIES

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, TRUSTEE,
PETITIONER,

vs.

RELIANCE INSURANCE COMPANY,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE
JOHN G. STREET, JR.
IN SUPPORT OF PETITIONER

TO THE HONORABLE SUPREME COURT
OF THE UNITED STATES:

THE INTEREST OF THE AMICUS CURIAE

Your amicus curiae is the attorney for Burton B. Paddock, Trustee in Bankruptcy for Stanford Con-

struction Company, which was adjudicated a bankrupt in Cause No. 2439 in bankruptcy in the United States District Court for the Northern District of Texas, Fort Worth Division; Trustee Paddock took over and completed two of his Bankrupt's contracts; the Bankrupt's bonding company, New Amsterdam Casualty Company, after the adjudication of bankruptcy made payments under the payment bond to unpaid laborers and materialmen. Hon. John Ford, Referee in Bankruptcy, held that the bonding company did not have a preferred claim to the retainages and payments due under the two contracts but should share in the proceeds with the other general creditors. The bonding company's petition for review is now pending in the United States District Court for the Northern District of Texas, Fort Worth Division. When the case at bar was before the Second Circuit, this *amicus curiae* filed, with the permission of that Court, an *amicus curiae* brief. This Court's decision will have an important bearing on the ultimate decision of the case involving the *amicus curiae's* client. This *amicus curiae* is vitally interested in the Court being as fully informed as possible in regard to the law involved. On June 25, 1962, this Court granted permission for the filing of this brief.

ARGUMENT

The opinion of the Second Circuit stated that the question to be decided was whether the surety who made payments under a payment bond is entitled by way of subrogation to the fund paid to the Trustee in Bankruptcy by the Government for work done prior

to the termination of the contract. (R. 52) The lower court then went on to say that it disagreed with the decisions in the Ninth and Tenth Circuits in *Phoenix v. Earle, 9 Cir. 1955, 218 F.2d 645* and *American Surety Co. v. Hinds, 10 Cir. 1958, 260 F.2d 366*, "holding the surety not entitled to subrogation." (R. 52-53) The Second Circuit was in error in this regard because both the *Hinds* and *Earle* cases held that the surety was subrogated to the rights of the laborers and materialmen, but that since laborers and materialmen have no enforceable rights against the United States, the surety could rise no higher than the basis of the subrogation, and thus the surety was only a general creditor, as it stood in the same position as those it had paid. The following language from the *Hinds* case at page 368 of the opinion is clear and concise as to what that court was holding:

> "The rights of a surety are largely derivative in nature. Having paid the laborers and materialmen, appellant may claim subrogation to their rights. But since laborers and materialmen have no enforceable rights against the United States the surety can rise no higher than the basis of the subrogation. The very purpose of the payment bond required under the Miller Act is to shift the ultimate risk of nonpayment from workmen and suppliers to the surety. The United States does not retain funds for that purpose for it is said:
>
> > "'But although we have assumed, for the purposes of another argument, that assurance that laborers and materialmen will be paid is one of the reasons for retaining the money, it

> seems more likely that completion of the work on time is the only motive. [Citations] It is hardly reasonable to withhold money in order to assure payments which perhaps can be made only from the money earned. In any event, we are not prepared to apply law relating to security to unappropriated sums which exist only as a claim.' United States v. Munsey Trust Co., 332 U.S. at Page 243, 67 S.Ct. at page 1603.

"It would seem clear that if the surety can claim no enforceable right of subrogation through the creditors paid and can assert no equitable claim to the fund itself, either in its own right or through the United States, then the Trustee must here prevail and appellant's claims must await their presentation under the administration of the bankruptcy proceedings. The Ninth Circuit has similarly concluded in Phoenix Indemnity Co. v. Earle, 218 F.2d 645."

The Second Circuit compares the *Heard Act, 33 Stat. 811 (1905)* and the *Miller Act, 40 USC, Sec. 270a (1935)* (R.54-56), and then says that the United States Government was under " 'equitable obligations to see that the laborers and supply men were paid,' ", (R. 56). If any such "equitable obligations" ever existed, it passed out of the picture when the *Miller Act* was passed requiring that a separate payment bond be furnished to insure the payment of laborers and materialmen. Prior to the *Miller Act* only one bond was required. The *Miller Act, 40 USC Sec. 270a*, provides for (1) a performance bond "for the protection of the United States," and (2) a payment bond "for the protection of all persons supplying labor and material". With the government requiring a good,

solid bonding company to be ready to pay any unpaid laborers or materialmen, who could fairly claim there was any other obligation owed by the United States Government—legal, moral, or otherwise—to the laborers and materialmen? For the sake of argument, assume that there was an "equitable obligation" on the part of the United States Government to see that the laborers and materialmen were paid. So what? Is there any right reposing there that a laborer or materialman could enforce against the United States? Of course there is none. *United States use of Hill v. American Surety Co.*, 200 U.S. 197, 203, 26 S.Ct. 168, 50 L.Ed. 437, 440; *Equitable Surety Co. v. United States, use of McMillian*, 234 U.S. 448, 455, 34 S.Ct. 803, 58 L.Ed. 1394, 1397; *United States v. Munsey Trust Co.*, 332 U.S. 234, 67 S.Ct. 1599, 91 L.Ed. 2022, 2028. In order to acquire a right by subrogation there must be an enforceable right to start with. There is no enforceable right on the part of a laborer or materialman against the United States Government, and the surety cannot acquire by subrogation what is not there to start with. This Court in *Munsey*, supra, stated that: " . . . nothing is more clear than that laborers and materialmen do not have enforceable rights against the United States for their compensation." (332 U.S. 234, 241, 91 L.Ed. 2022, 2028) It was also held by this Court in *Munsey* that: " . . . it is elementary that one cannot acquire by subrogation what another, whose rights he claims, did not have. Once the laborers and materialmen have been paid, whether by contractor or surety, they have no rights in any fund." (332 U.S. 234, 242, 91 L.Ed. 2022, 2029).

The Second Circuit makes the statement that:

> "Moreover, the fact that 'laborers and materialmen have no enforceable rights against the United States,' 260 F.2d at page 368, is beside the point. The question is not whether the laborers and materialmen have rights enforceable against the Government, but whether they have an equitable priority in the retained payments." (R.57)

What kind of Mumbo Jumbo is that? If a person has a priority, whether it be by virtue of an equitable cause of action or an action at law, he has an enforceable right. If he has no enforceable right he has no priority.

This Court held in *Munsey* that the United States is under no legal obligation to pay the laborers and materialmen. If the United States is not legally liable to laborers and materialmen, then it must follow that the laborers and materialmen have no legal remedy and that the surety can acquire none by way of subrogation. The Second Circuit has in effect held that the laborers and materialmen on a job for the United States have some sort of nebulous, unenforceable right against the United States that by subrogation is turned into an enforceable right on the part of the surety.

In *Munsey* this Court indicated that it felt it more likely that completion of the work on time is the only motive for the United States of America retaining payments prior to completion. That the retainage is retained by the government for the sole purpose of insuring completion of the project is shown by the

statutory provision that appears in almost all United States of America contracts which provides that the contracting officer, at any time after 50% of the work has been completed, if he finds that satisfactory progress is being made, may make any of the remaining partial payments in full, and that on completion and acceptance of each separate building, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made in full, including retained percentages thereon. There is no requirement that a contractor prove that he has paid his laborers and materialmen before he is entitled to payment.

The Ninth Circuit has also held in line with the petitioner's position in the case of *Phoenix Indemnity Company v. Earle (Ninth Cir. 1955) 218 F.2d 645.* That case involved the question of priority as between United States tax liens and a surety which had paid materialmen and laborers of the prime contractor. In that case the contractor completed the job. Before any payments were made by the surety and before bankruptcy, the government filed tax liens. After the tax liens were filed the surety paid under its payment bond $15,210.60 for labor and material. The United States Government paid the balance due under the contract of $11,838.61 to the trustee in bankruptcy. In holding that the tax liens were superior to the claim of the surety, the court stated that it is true the surety is subrogated to the rights of the creditors whose claims it paid, but *that those creditors (the laborers and materialmen of the prime contractor) had no lien or oth-*

er enforceable right against the agency of the United States Government or the funds owing to the bankrupt contractor. The Court stated that the claims of laborers and materialmen against the estate of the bankrupt are general and unsecured, and that *Section 57, Sub. i (11 U.S.C.A. § 93, Sub. i)* confines the secondary debtor to a proof of the creditor's claim in the creditor's name.

In its opinion the Second Circuit cites *Henningsen v. U. S. Fidelity & G. Co. (1907) 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547,* for the proposition that the Government is under an equitable obligation to see that the laborers and supply men were paid. Of course, after *Henningsen* was decided, the *Miller Act* was passed which provided for a separate payment bond for laborers and materialmen. Also, the *Henningsen* case was not well reasoned as *Prairie State Natl. Bank v. U.S., 164 U.S. 227, 17 S.Ct. 142, 41 L.Ed. 412,* the only case relied upon by the Court in *Henningsen,* was not in point. *Henningsen* was a "payment bond" case involving payments by the surety to unpaid laborers and materialmen, and the surety had not completed the job. The *Prairie State National Bank* case was a performance bond case in which the surety took over and completed the unfinished contract, and that Court held the surety was entitled to the retainages because if the United States had been forced to complete the job it could have used the retainages for completion.

The Second Circuit cites *Belknap Hardware & Mfg. Co. v. Ohio River Construction Co., 6th Cir. 1921, 271*

Fed. 144, (R. 55), with the statement that the Belknap case commented upon the *Henningsen* case and spelled out "in no uncertain terms" the priority of materialmen and laborers. When the *Belknap* case is analyzed it is not in point because (1) the bond did not have anything to do with the matter—the Court stating at page 146:

> "Further, we cannot see that the bond has anything to do with the matter. A judgment on the bond would be worthless, and the claimants do not ask any such judgment. While the only purpose of the statutory bond is to enable the United States and materialmen and laborers to collect from the sureties their claims against the contractor, it may be (the point has not been argued and is not decided), that, if claimants have an equitable priority in the fund over mere general creditors, the relations between themselves and the sureties may also give them priority over the claims of the sureties for material and labor, if such claims they have; but with this exception, we think whatever is said about the bond in the bill of complaint is surplusage, and we must look to the remainder to find a meritorious case."

(2) the laborers and materialmen in the *Belknap* case had not been paid; (3) the surety in the *Belknap* case was insolvent; (4) the *Miller Act* has been passed since the *Belknap* case was decided and requires a separate payment bond for the protection of laborers and materialmen, whereas, there was only one bond required at the time the *Belknap* case arose and the United States had a priority for the full satisfaction of all its claims for completion or delay before any protec-

tion was afforded the unpaid laborers and materialmen. In quoting from the *Belknap* case, the Second Circuit omitted from the middle of its quotation the more interesting language of the opinion (R. 55). The two sentences, which were omitted in the court's quotation from the *Belknap* case are as follows:

> "The case [Hennigsen] was essentially different from the Prairie State Bank case, because there the surety had taken over and completed the contract and the performance of the contractor's obligation to the United States as the other party to the contract, and so had become entitled to the security which the United States held against the contractor; in the Henningsen Case, the contractor himself had completely performed the contract and had finished the work. It would seem, therefore, that subrogation in the Henningsen Case could not be to any security which the United States held against the contractor; there was no such element in the case."

The Court in the *Belknap* case recognized that the *Prairie State Bank* case was "essentially different" from the *Henningsen* case. This points up the fact that the *Henningsen* case is wrong, and the reason the Court arrived at the wrong result in the *Henningsen* case was because it thought the *Prairie State Bank* case was in point, when it clearly was not. The Court in *Henningsen* made the statement, "Prairie State Nat. Bank v. United States, 164 U.S. 227, 41 L.Ed. 412, 17 Sup. Ct. Rep. 142, is in point."

The *Belknap* case then "backs in" to the decision of the case by saying that since *Henningsen* said there

was subrogation, even though the *Prairie State Bank* case upon which *Henningsen* relied was not in point, there must have been some right to which the surety was subrogated, even though *Henningsen* did not say what the right was. This is a perfect example of putting the cart before the horse. The Court in the *Belknap* case indicates at page 149 that the right to which the surety was supposedly subrogated was not stated in very express terms in the *Henningsen* opinion. That is somewhat of an understatement—the supposed "right" was not described at all.

The Second Circuit, after referring to the legislative history of the Miller Act. (R. 56), says that the purpose of both the Heard and Miller Acts was to make sure that the materialmen and laborers "should be secured out of *the job itself* rather than on the general credit of the prime contractor." [Emphasis supplied] That just was not the purpose. If a materialman's or laborer's payment is secured "out of the job itself", it can only mean that he has a lien on the "job". A materialman or laborer has no lien on a Government job. He had none under the Heard Act, and he had none under the Miller Act. The purpose of Congress in passing the Miller Act was to require a payment bond that the materialmen and laborers could look to for payment. It would have made very interesting reading if the Second Circuit would have detailed steps by which a materialman or laborer allegedly can secure his payment "out of the job itself." In the Appendix to this brief is copied all of the Congressional history on the Miller Act that this writer could find. There is not one thing in that his-

tory to indicate Congress thought the materialmen and laborers could be secured "out of the job itself". Instead it clearly shows that the purpose was to require a separate payment bond out of which the materialmen and laborers would be paid.

Mr. Miller, in explaining the purpose of the Miller Act to his fellow Representatives, stated that the Act " . . . provides for two bonds, *one for the protection of the Government's interests*, and *the other for the protection of the rights of labor, the subcontractors, and material furnishers." 79 Congressional Record 11702.* [Emphasis supplied] Mr. Miller was telling the House of Representatives that the performance bond would protect all of the "Government's interests". If the laborers and materialmen on a Federal project had any enforceable rights against the Government; Representative Miller would not have indicated that all the Government's interests were protected by the performance bond; he would have included the Government as being protected by the payment bond—but he didn't, for he knew materialmen and laborers had no enforceable rights against the Government in connection with work on a Federal project.

In the Senate, Senator Burke indicated the performance bond was for the protection of the Government and the payment bond for the protection of materialmen and laborers. *79 Cong. Record 13382.*

The *Restatement, Security § 141, pages 383-384*, discusses the meaning of subrogation. It says at page 384 that subrogation " . . . is a mode which equity

adopts to compel the discharge of a debt by the one who in good conscience ought to pay it." This shows that the surety company should not obtain a preference over the general unsecured creditors of the bankrupt; because there is no one to whom the surety can point and say: "In good conscience you ought to pay my claim ahead of all others." At page 384 the *Restatement, Security further states:*

> "Subrogation, as a creation of equity, is subject to the limitation that it will not be allowed where it will prejudice the creditor or be inequitable to third persons."

Even if there were any enforceable rights to which the surety could be subrogated, it would be inequitable to prefer the surety, which knowingly assumed the risk for a premium, over general unsecured creditors of the bankrupt, and subrogation should not be allowed.

If the Trustee prevails in this case, the surety company will not suffer any great loss, for it will receive a pro rata share of the dividends along with the other general unsecured creditors. As stated in *American Surety Co. v. Sampsell, 1945, 327 U.S. 269, 274, 66 S.Ct. 571, 90 L.Ed. 663, 667,* equitable principles govern the distribution of a bankrupt's assets. The surety company has received a premium for the risk it took on the payment bond, while the other general creditors were not so fortunate. It would certainly comport with equitable principles to allow the general creditors to share equally with an insurance company surety who received a premium to take a known risk. In the

Sampsell case, supra, this Court held that a surety company which had paid laborers and materialmen up to the limit of its bond could not share in bankruptcy dividends so long as there remained unpaid any creditor of the class for whose protection the bond was intended, even though the unpaid creditors may not have complied with statutory provisions in regard to notice and filing.

If this Court were to hold that a surety which makes payments under its payment bond without doing anything in connection with its performance bond has a prior claim over general creditors of a bankrupt contractor, it would lead to the anomalous result that if a Trustee had taken over and completed a contract of his bankrupt, a surety company which made payments under its payment bond after bankruptcy would have a prior claim to the Trustee (who represents the general creditors). The writer represents a Trustee in this exact situation—on the date of bankruptcy two jobs for the United States of America were not completed; the Trustee took over and completed the two jobs; the bonding company, after bankruptcy, made payments under its paymend bond in satisfaction of debts incurred by the contractor with laborers and materialmen prior to the date of bankruptcy, and the bonding company is contending that it is entitled to receive the contract funds.

CONCLUSION

It is respectfully submitted that this Court should reverse the decisions of the Second Circuit and the

United States District Court for the Western District of New York and affirm the decision of Referee in Bankruptcy, James R. Privitera. This would result in an equitable solution of the case as Respondent, Reliance Company, would share pro rata with the other general unsecured creditors.

Respectfully submitted,

John G. Street Jr

John G. Street, Jr.
Amicus Curiae

I hereby certify that I have served a copy of the foregoing brief on Hon. Raymond T. Miles, 942 Ellicott Square Building, Buffalo 3, New York, Petitioner's counsel of record, and Hon. Mark N. Turner, 440 M & T Building, Main and Swan Streets, Buffalo 2, New York, Respondent's counsel of record, by depositing, on August 3, 1962, a copy of same in a United States mail box with airmail postage prepaid, addressed to each of the above-named counsel of record at the post office address set forth above.

John G. Street Jr

John G. Street, Jr.
Amicus Curiae

APPENDIX

At *79 Congressional Record 11702* appear the following proceedings of the House of Representatives:

* * * (Omitted is Mr. Miller's request for unanimous consent for consideration of the bill and Mr. Martin's request for an explanation of the bill)

"Mr. MILLER. This bill merely provides that in the construction of public buildings and other public works there shall be two bonds, one for the performance of the contract with the Government, and the other a payment bond for the protection of subcontractors and those furnishing the labor and material.

Under the present law we have but one bond, with a dual obligation, but it is not satisfactory in that it does not afford protection to the subcontractors, materialmen, and laborers.

This merely provides for two bonds, one for the protection of the Government's interests, and the other for the protection of the rights of labor, the subcontractors, and material furnishers. It permits the filing of a suit on the payment bond 90 days after the work has been done, or material furnished.

"Mr. MARTIN of Massachusetts. It gives protection to the subcontractors."

"Mr. MILLER. That is right.

"Mr. MARTIN of Massachusetts. Was it a unanimous report from the committee?"

"Mr. MILLER. Yes; so far as I know, no opposition developed.

"The SPEAKER. Is there objection?

"There was no objection.

"* * * (The Clerk read the bill).

"The bill was ordered to be engrossed and read a third time, was read the third time, and passed, and a motion to reconsider was laid on the table."

At *79 Congressional Record 13382*, appear the following proceedings of the Senate:

"Mr. McKELLAR. Mr. President, may we have a statement as to this bill?

"Mr. METCALF. Mr. President, I have just received a communication from certain builders who asked if they could not have a hearing on an amendment they would like to have attached to this bill. I know nothing about the bill, not having read it, but I understand there will be no objection to taking this course.

"Mr. McKELLAR. Let it go over.

"Mr. BURKE. Mr. President, I should like to make a statement regarding the bill.

"The PRESIDING OFFICER. Does the Senator from Tennessee withhold his objection?

"Mr. McKELLAR: I withhold the objection.

"Mr. BURKE. Mr. President, this bill proposes to amend what is known as the "Heard Law." It provides, in the case of contracts with the Government in an amount more than \$2,000 that the contractor shall be required to give two bonds instead of one, as at the present time. Under the present law a performance bond is given for the protection of the Government. This bill would amend that law by requiring an additional bond, a payment bond, for the protection of materialmen and laborers, subcontractors, and all who put forth their labor or furnish materials or incur expenditures in connection with the work.

The House Judiciary Committee held hearings on the bill, all the different groups were represented, and this bill was finally passed by the

House. The Senate committee did not hold any hearings.

"Mr. WALSH. Mr. President, will the Senator yield?

"Mr. BURKE. I yield.

"Mr. WALSH. Is this an amendment to the Bacon-Davis law?

"Mr. BURKE. This is an amendment to what is known as the 'Heard Act.'

"Mr. WALSH. As I understand, the bill will require a contractor, in furnishing a bond, not only to be liable for default by reason of his inability to complete the contract or by reason of failing to meet the requirements and specifications as to material, but will require him to meet the claims of workers and employees who do not receive their compensation.

"Mr. BURKE. That is the point exactly.

"Mr. WALSH. Of course, it is a most meritorious bill, and should be enacted.

"Mr. McCARRAN. Mr. President, will the Senator from Nebraska yield to me?

"Mr. BURKE. I yield.

"Mr. McCARRAN. It will do just a little more than what the Senator from Massachusetts has in mind. In other words, under the existing law one who has furnished material or labor in the construction of a Federal building must wait for 6 months after the acceptance of the building before he may institute suit to recover on the obligation to him. This bill, as I now recall, changes that situation so that he may sue within 90 days.

"Mr. ASHURST. That is correct.

"Mr. McCARRAN. To that extent it works to the benefit of the materialman and the laboring man as well.

There are two points involved, one relating to the performance of the contract. The other is that the materialman and the laborer may sue and be heard within a shorter time than under the existing law.

"Mr. WALSH. Mr. President, I will say to the Senator from Nevada and to the Senator from Nebraska that the investigation conducted by the subcommittee of the Committee on Education and Labor showed a deplorable condition with reference to the way employees on public buildings were defrauded and cheated of their wages, and any measure that will tend to strengthen their rights and help them secure their compensation is justified.

"Mr. McCARRAN. That is the object of the pending bill, and I might augment what the Senator from Massachusetts has said as to what has been shown by the hearings to which he has referred.

"Mr. WALSH. I did not believe it was possible for men repeatedly to get contracts from the Federal Government and chisel, the way some of them do, against the wages of the employees.

"Mr. ROBINSON. Mr. President, may I ask what objection is urged to the bill?

"Mr. ASHURST. There is no objection.

"Mr. ROBINSON. It is apparent that if the bill is to be considered, no opportunity can be afforded now to hold hearings on it. That would carry it over for the session.

"Mr. METCALF. Mr. President, I withdraw my objection.

"The PRESIDING OFFICER. Is there objection to the present consideration of the bill?

"There being no objection, the Senate proceeded to consider the bill, which was ordered to a third reading, read the third time, and passed.

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT RELIANCE INSURANCE COMPANY

MARK N. TURNER,
Attorney for Respondent,
440 M & T Building,
Buffalo 2, New York.

BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

INDEX.

TABLE OF CASES CITED.

STATUTES.

Miscellaneous.

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT RELIANCE INSURANCE COMPANY

Statement

The petitioner's statement relates most of the essential facts, but there are a few additional details which we believe should be called to the Court's attention.

The matter was brought on before the referee in bankruptcy by the respondent's petition (pages 2-6 of the Transcript of Record),[1] upon which the referee granted his order to show cause directed to all the bankrupt's creditors (TR 1-2).

---

[1] The reference to the Transcript of Record will hereafter be "TR".

Following the return of the order to show cause, the attorney for the trustee—the petitioner herein, and the attorneys for the respondent entered into an Agreed Statement of Facts, which is found at pages 19-25 of the Transcript of Record.

In addition to the matters set forth in petitioner's "Statement of Facts", the following facts were stipulated:

1. There were no appearances by or on behalf of any creditor or interested person, other than the parties to this appeal, who asserted any claim to the $87,737.35 fund here involved (TR 20).

2. That there now remains no known unpaid laborers or materialmen, who furnished labor, materials or services in connection with the Dutcher prime contract (TR 22).

3. That the surety (respondent) paid *claims* under its payment bond, in addition to the sum of $326,248.42, set forth on page 3 of petitioner's brief, the sum of $18,878.47, as required by the Decision of the Court of Appeals for the Second Circuit, in *U. S. v. Fire Association of Philadelphia*, 260 Fed. (2d) 541, and an additional claim of $4,045.92, making a total of *claim payments* of $349,172.81 (TR 22). This is exclusive of attendant expenses paid, amounting to $20,754.34 (TR 21).

4. That the surety-respondent duly made claim to the fund here in question (TR 24-25).

Summary of Argument

The surety-respondent's position is:

1. It took an assignment from the contractor assigning to the respondent, in the event of the contractor failing to pay his bills, all future contract moneys (TR 10-11).

2. It paid all the contractor's bills for labor, materials and services on the contractor's prime contract on the St. Lawrence Seaway, in accordance with its bond obligation entered into contemporaneously with the contract:

The failure of the bankrupt to promptly pay those bills was a "default" on his part.

> *Massachusetts Bonding and Insurance Company v. State of New York*, 259 Fed. (2d) 33, 37-38 (C. A. 2, 1958).

3. That the $87,737.35 fund here in controversy are contract moneys which are the fruit of the labor and material bills which the surety guaranteed to pay and did pay.

4. That by reason of the foregoing, the petitioner is entitled to receive the fund here involved on the following grounds:

   A. By subrogation to the rights of the owner in the contract moneys—the fund here involved.

   B. By subrogation to the rights of the laborers and materialmen who se claims the surety paid.

   C. By direct assignment of the contract moneys by the contractor, long prior to bankruptcy, to the surety.

5. That the bankrupt, at the time of the bankruptcy, had "no property" in the fund here involved, which could pass to its trustee—the petitioner herein.

POINT I

The surety-respondent, pursuant to its obligation under the payment bond, having paid and satisfied the job creditors on the bankrupt's prime contract, became the equitable owner of, and is now entitled to receive, the contract moneys earned by the bankrupt prior to bankruptcy.

The payment bond (TR 15-17) here involved was given pursuant to the provisions of the Miller Act (40 U.S.C.A. 270 ff) in connection with the construction of a portion of the St. Lawrence Seaway, by the Corps of Engineers, on behalf of the United States Government. It obligated both the bankrupt-prime contractor, as principal, and the surety-respondent, as surety, to "promptly make payment to all persons supplying labor and material in the prosecution of the work" (TR 18).

The surety also furnished the required performance bond (TR 15-16).

The appellant, while admitting that the surety would have been entitled to prevail if it had paid out its money *to complete the prime contractor's contract pursuant to its obligations under the performance bond*, urges that because the surety's payments were made *pursuant to its obligations under the payment bond*, it must be relegated to the position of a general creditor, with no special or prior rights to the earned contract moneys—the fund here in question.

We respectfully urge there is no basic difference between the surety's position on a payment bond, as distinguished

from a performance bond. In both instances the surety's money pays for the material and labor going into and forming the improvement, and, in both instances, pays for them pursuant to its obligation and duty so to do under the bonds which it wrote.

The earliest leading performance bond case is *Prairie State National Bank v. U. S.*, 164 U. S. 227 (1896), where the contestants were 1) the contractor's surety who had completed the contractor's contract and 2) an assignee bank. This Court recognized the surety's superior equitable rights and awarded the fund to it.

The leading payment bond case is *Henningsen v. U. S. F. & G. Co.*, 208 U. S. 404, 28 S. Ct. 389 (1908), where the contest was between: 1) a contractor's surety who had paid the contractor's labor and material bills under a payment bond and 2) an assignee bank to whom the contractor had assigned his rights to the contract moneys as security for a loan. Here likewise, this Court recognized the surety's superior equitable rights and awarded the fund to the surety.

During the course of its opinion in the *Henningsen* case this Court, at page 391 of the Supreme Court Reporter said: "*Prairie State National Bank v. U. S.*, (citation) is in point".

THE BASES OF THE SURETY'S RECOVERY

The theories or bases of the surety's recovery have been variously indicated or expressed in the cases. These bases are:

1. Subrogation to the rights of the owner to the contract moneys.

2. Subrogation to the rights of the laborers and materialmen to the contract moneys.

3. Assignment to the surety by the contractor of his rights to the contract moneys.

1. Surety's subrogation to the rights of the owner to the contract moneys.

The rationale here is that the government's statutory requirement that the contractor furnish a payment bond was a recognition of its interest and equitable obligation that the laborers and materialmen be paid. Stemming from this interest and obligation there arose a "right" to use the unpaid contract moneys to pay laborers and materialmen. Consequently, when the surety, under its payment bond, paid the laborers and materialmen, it was subrogated to the rights of the government to the unpaid contract moneys.

An early illustration of the government's concern that suppliers on government jobs be paid is *U. S. v. American Surety Co.*, 200 U. S. 197, 50 L. Ed. 437. The case was decided in 1906, but dealt with events which occurred in 1894 at a time prior to the 1905 Amendment to the Heard Act (August 13, 1894, ch. 280, 28 Stat. 278) and under which the government did not require the "performance" feature of the bond required under the 1905 Amendment (Act of February 24, 1905, ch. 778, 33 Stat. 811).

The 1905 Amendment, when read in the light of the 1894 Act, this Court said at page 202: "* * * shows the consistent purpose of Congress to protect those who furnish labor or material in the prosecution of public work".

The *Prairie State National Bank* case, 164 U. S. 227, (1896) proceeded on the theory that the surety for performance, on completing the defaulting contractor's work, succeeded or became subrogated to the government's rights—for its own protection—in the contract moneys.

In the *Henningsen* case, 208 U. S. 404, 28 S. Ct. 389 (1908) this Court said the *Prairie State Bank* case was "in point" where the surety paid the defaulting contractor's labor and material bills. This would seem to indicate that the surety succeeded or became subrogated to the government's rights—for the protection of laborers and materialmen—in the contract moneys.

We are not unmindful of the explanation of the rationale of the *Henningsen* case, set forth in *Belknap Hardware Co. v. Ohio River Co.*, 271 Fed. 144 (C. A. 6, 1921), which is the one adopted both by the District Court (TR 46) and by the Court of Appeals (TR 55). We shall discuss this ground of recovery shortly.

In other cases the Courts have awarded the contract fund to the surety on the theory of subrogation to the rights of the government to the contract funds.

National Surety Corp. v. U. S., 133 Fed. Supp. 381 (Court of Claims 1955), cert. denied *sub nom. First National Bank in Houston v. U. S.*, 350 U. S. 902, 76 S. Ct. 181. This was a payment bond case and the surety's adversary was an assignee bank.

In *Continental Casualty Company v. U. S.*, 169 Fed. Supp. 945 (Court of Claims 1959)—a payment bond case, where the surety's adversary was the contractor's trustee in bankruptcy, the Court held that the surety, in paying the contractor's laborers and materialmen, satisfied two (2) obligations of the contractor, 1) to the laborers and materialmen whose bills it paid and 2) to the United States "which was a preferred creditor because of its possession of funds which could be used as an offset against the contractor". The Court then added at page 947:

> "By satisfying the latter obligation, *the plaintiff surety became entitled to be subrogated to the security*

which the United States held, i.e., the funds in its hands" (Emphasis ours).

This is the clearer doctrinal basis as suggested in a well annotated article in 71 Yale Law Journal 1274 (June 1962) entitled "Reconsideration of Subrogation Rights of the Miller Act Payment Bond Surety".

In *Philadelphia National Bank v. McKinlay*, 72 Fed. (2d) 89, (C. A. D. C. 1934) cert. denied, 293 U. S. 583, 55 S. Ct. 96, both the contractor and surety were insolvent. *The government retained the contract fund* pending a decision of the Court. The fund was claimed by the contractor's trustee and the several unpaid materialmen. The Court at page 91 wrote:

> "The obligation of the surety was to pay these debts. *If this obligation had been discharged, the fund now in the hands of the government would belong to it. * * * In no case could the fund be considered as due to the bankrupt, and hence to its trustee,* * * *" (Emphasis ours).

To the same effect are:

Morgenthau v. F. & D. Co. of Md., 94 Fed. (2d) 632, 635 (C. A. D. C. 1937);

Massachusetts Bonding & Insurance Company v. State of New York, 259 Fed. (2d) 33, 38 (C. A. 2 1958);

In Re Cummins Constr. Corp., 81 Fed. Supp. 193, 197 (D. C. Md. 1948);

Matter of William P. Bray Company, 127 Fed. Supp. 627, 628 (D. C. Conn. 1954) a non-federal government job;

Danais v. M. DeMatteo Constr. Co., 102 Fed. Supp. 874, 876 (D. C. N. H. 1952) a non-federal government job;

In Re Collins & Kiser Construction Co., 204 Fed. Supp. 42 (D. C. Iowa 1962) an Iowa State Highway Job.

In the case at bar we do not have the situation present in *American Surety Company v. Westinghouse Electric Mfg. Co.*, 296 U. S. 133, 56 S. Ct. 9 (1935), where the surety's bond was not large enough to pay all the job creditors. There the job creditors' rights came ahead of the surety until they received full payment. Here the surety has paid all job creditors. The case illustrates, however, the nature and extent of the materialmen's interest in the contract moneys, to which the surety in the case at bar became fully subrogated, as we shall next discuss.

2. Surety's subrogation to the rights of laborers and materialmen to the contract moneys.

This is the basis for the surety's recovery adopted by the District Court (TR 46) and the Court of Appeals (TR 54-56).

Here the rationale proceeds, in the first instance, as on the first basis previously discussed, *viz.*, the interest or equitable obligation of the government that laborers and materialmen be paid. The statutory payment bond, whether embraced within the combination bond under the 1905 Amendment to the Heard Act (Act of February 24, 1905, ch. 788, 33 Stat. 811) or the separate payment bond under the Miller Act (40 U. S. C. A. 270 ff) did not eliminate or cut down the rights of the laborers or materialmen. Indeed, it gave the laborers and materialmen additional rights—legally enforceable rights under the payment bond required by Congress for their *added protection*. Their equitable rights in the contract moneys continued unabated.

Thus, when the surety under the payment bond paid the laborers and materialmen, it became subrogated to their rights in the contract moneys. This equitable obligation

of the government to see that the materialmen and laborers were paid "* * * would seem sufficient to support the claim of the surety for priority, * * *" (Court of Appeals Opinion TR 56).

In the *Henningsen* case (208 U. S. 404) at page 410, this Court held:

> "It (the surety) paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the government from all equitable obligations to see that the laborers and supplymen were paid. It did this not as a volunteer, but by reason of contract obligations entered into before the commencement of the work".

In *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 271 Fed. 144 (CA-6 1921) that Court, in spelling out the basis of the surety's recovery in the *Henningsen* case, wrote at pages 148-149:

> "In that case (*Henningsen*), the surety upon a bond of this kind (a payment bond), given pursuant to the 1894 statute, and who had been compelled to pay its surety obligation, was held entitled to priority in the retained fund as against a general creditor of the contractor. * * * The surety's claim of priority in the fund was sustained, and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated."

Mechanic's Lien laws are provided for in many of the states and these laws have long been given special recognition by Congress. Section 67 (b) of the Bankruptcy Act, 11 U. S. C. A. 107 (b) provides that a mechanic's lien afforded by state law gives to the mechanic's lienor the

right to file and perfect his mechanic's lien, within the time provided by state law, even though within four (4) months of, or even after, bankruptcy; and that payment thereof shall not constitute a preferential lien or transfer.

In other words, payment from the contract funds, to the extent necessary to satisfy the claim of a laborer's or materialman's mechanic's lien claim does not "deplete" the bankrupt contractor's "estate".

> *Ricotta v. Burns Coal & Building Supply Company*, 264 Fed. (2d) 749 (C. A. 2 1959).

To the same effect are:

> *Albert Pick Co. v. Travis*, 6 Fed. Supp. 486 (D. C. Eastern District of New York 1933);
>
> *In Re Heintzelman Constr. Co.*, 34 Fed. Supp. 109 (D. C. Western District of New York 1940).

In *National Surety Corporation v. United States*, 133 Fed. Supp. 381 (Ct. of Claims 1955), cert. denied *sub nom. First National Bank in Houston v. U. S.*, 350 U. S. 902, 76 S. Ct. 181, the Court of Claims indicated (page 383) that the rights given to the laborers and materialmen under a Miller Act bond are akin to the mechanic's lien rights afforded suppliers on non-federal construction jobs. In the words of the Court of Claims the United States, "* * * is under no legal liability to pay laborers and materialmen; but it is under an equitable obligation to do so. To discharge this equitable obligation, Congress passed the Miller Act, * * *".

3. Assignment to the surety by the contractor of his rights to the contract moneys.

In many cases the contractor, at the time of his securing the bond or bonds from the surety, executes and delivers to his surety an assignment of all his rights to receive the

contract moneys in the event of a breach of the bond or contract.

Such an assignment is present in this case. It is Exhibit "A" of the surety's petition to have the moneys here in controversy paid to it (TR 6-14). It is stipulated in Item 2 of the Agreed Statement of Facts (TR 19-25 at page 20).

The essential language of the assignment is as follows:

> "* * * the Indemnitors (the bankrupt contractor-principal) do hereby assign, transfer and set over, to the surety * * * such assignment to become effective as of the date of said bond or bonds, but only in the event of any such abandonment, forfeiture or breach as aforesaid—
>
> c. Any and all percentages of the contract price retained on account of said contract, and any and all sums that may be due under said contract at the time of such abandonment, forfeiture or breach, or that thereafter may become due;"

Prior to bankruptcy, on August 30, 1956, the contractor defaulted in the payment of his labor and material bills and the surety in response to its obligations under the payment bond paid $326,248.42 of such bills. It later also paid other payment bond obligatioins, to bring the total to $349,172.81, exclusive of expenses of $20,754.34. (Items 6-9 of Agreed Statement of Facts—TR 21-22.)

It was stipulated that as a result of said payments there remained "* * * no known unpaid laborers of materialmen who furnished labor, materials or services in connection with the Dutcher prime contract" (TR 22).

The rationale of this basis of recovery (not relied upon by either the District Court or the Court of Appeals here) is that the assignment effectively divests the contractor

of any and all rights to the contract moneys operative in the event of a breach of the contract or bond; and, upon such breach, the surety enjoys paramount right and title to the contract moneys.

In *Martin v. National Surety Co.*, 300 U. S. 588, 57 S. Ct. 531 (1937) the lower Court, in a payment bond case, where the contestants were the insolvent contractor's surety and a non-surety assignee, had awarded the fund to the surety as the subrogee of the laborers and materialmen, holding that the assignment was ineffective under 31 U. S. C. A. 203.

This Court held that despite the prohibition against the assignment contained in 31 U. S. C. A. 203, it was valid and enforceable against all persons after the interests of the government had been served. The opinion further pointed out the contractor's failure to pay his bills; that this was a breach of the condition of the bond and held at page 598:

> "The terms of the bond are read into the contract and *there is default under the contract when there is default under the bond*". (Emphasis ours)

This Court, after remarking at page 593 that its decision was being kept "within the necessities of the specific controversy", held that the non-surety assignee received the contract moneys with notice of the surety's rights, and that with such notice, he knew that the contract moneys "* * * became a fund to be devoted in the first instance to the payment of materialmen and others similarly situated" (page 593).

This Court then held at pages 593-594:

> "In our view of the law, the equities in favor of materialmen growing out of that agreement (the assignment) were impressed upon the fund in the possession of the court".

This Court, however, *did not disapprove the basis of the holding of the lower court* in favor of the surety, for in the closing sentence of its opinion, at page 598, it stated:

> "Without denying the possibility of arriving at the same conclusion through over avenues of approach, we follow the pathway that has been marked in this opinion".

Where the interests of the government have not been involved other assignments have been held valid, despite the provisions of 31 U. S. C. A. 203:

> *U. S. v. Aetna Casualty & Surety Co.*, 338 U. S. 366, 70 S. Ct. 207 (1949);
>
> *Lacy v. Maryland Casualty Company*, 32 Fed. (2d) 48 (C. A. 4 1929).

In *U. S. v. Munsey Trust Co.*, 332 U. S. 234, 67 S. Ct. 1599 (1947)—a government set-off case, which we will discuss more in detail later—this Court, in footnote 1 of its opinion, at page 237, in speaking of the contractor's assignment to its surety, said:

> "These assignments were of course invalid against the United States. R. S. Sec. 3477, 31 U. S. C. Sec. 203, 31 U. S. C. A. Sec. 203; *Martin v. National Surety Co.*, 300 U. S. 588, 57 S. Ct. 531, 81 L. Ed. 822, *but they enable the surety to prevail over the contractor if there is contest between them*" (Emphasis ours).

See also:

> *Central Bank v. U. S.*, 345 U. S. 639, 73 S. Ct. 917, (1953) at page 642.

THE MUNSEY TRUST CASE

Following the *Prairie State National Bank* case (164 U. S. 227) in 1896, and the *Henningsen* case (208 U. S. 404) in 1908, there was little or no dispute as to the surety's

paramount rights to the contract balances, in circumstances here present, under either a payment or a performance bond, until this Court's decision in *United States v. Munsey Trust Co.*, 332 U. S. 234, 67 S. Ct. 1599 (1947).

In that case, however, the government was more than a stakeholder. It held contract moneys earned by a contractor on several bonded federal jobs, but the contractor owed the government excess completion costs on an unbonded federal job. This Court permitted the government to set off against the earned contract moneys on the bonded jobs, its loss on the unbonded job.

This Court, after clearly indicating in footnote 1, the surety's superior rights under its assignment where the rights of the government were not involved, and citing *Martin v. National Surety Co., supra* (300 U. S. 588), carefully wrote at page 240:

> "*From Prairie State Nat. Bank of Chicago v. United States*, (*citation*) to *American Surety Co. v. Sampsel*, (citation) *we have recognized the peculiar equitable claim of those responsible for the physical completion of building contracts to be paid from available moneys ahead of others whose claims come from the advance of money. But in all those cases, the owner was a mere stakeholder and had no rights of its own to assert*" (Emphasis ours).

It is helpful to note that while the surety involved in the *Munsey Trust* case, *supra*, paid bills under its payment bond, this Court, in the quotation above set forth, cited both the *Prairie State National Bank* case (164 U. S. 227), decided in 1896, *which involved a performance bond*, and *American Surety Co. v. Sampsell* (327 U. S. 269), decided in 1946, *which involved a payment bond*. And, of course, included within the time-span of those two (2) decisions was the *Henningsen* case (208 U. S. 404), decided in 1908, which also involved a payment bond.

The principal case relied upon by the trustee in bankruptcy of the contractor is *American Surety Company of New York v. Hinds*, 260 Fed. (2d) 366 (C. A. 10 1958), which professes to find in this Court's decision in the *Munsey Trust* case a repudiation of the doctrine of the *Prairie State National Bank* case (164 U. S. 227) and particularly the *Henningsen* case (208 U. S. 404).

In *National Surety Corp. v. U. S.*, 133 Fed. Supp. 381, (Court of Claims 1955), cert. denied *sub nom. First National Bank in Houston v. U. S.*, 350 U. S. 902, 76 S. Ct. 181, the Court of Claims said at page 383:

> "We reiterate our former opinion that the equity of the surety company is superior to the rights of the bank acquired under an assignment, *whether the surety's rights are derived from the discharge of its liability on a performance bond or on a payment bond.* In *Prairie State Nat. Bank, supra,* the surety had discharged its liability on a performance bond, and in *Henningsen, supra,* its liability on a payment bond" (Emphasis ours).

And at page 384, the Court said:

> "In *United States v. Munsey Trust Co., supra;* the Supreme Court said that the United States was not legally liable to laborers and materialmen, but it did not say that laborers and materialmen could not assert an equitable claim to moneys in the hands of the United States payable under the contract. We think they can".

The Court of Appeals, in the case at bar, in its opinion at page 58 of the Transcript of Record (298 Fed. (2d) 655, at page 659) said:

> "It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and subrogation that, as we have already pointed out, were so well established under the Heard Act."

In *Royal Indemnity Co. v. U. S.*, 93 Fed. Supp. 891 (Ct. of Claims 1950) the contest was between the surety on a government contract, who had paid job creditors of a prime contractor *under a payment bond*, and an assignee bank. The government was a mere stakeholder. The surety prevailed.

In commenting on the *Munsey Trust* case (332 U. S. 234) and the views of the several Courts concerning it, including the Court of Appeals of the State of New York, in the *Triborough Bridge* case, 297 N. Y. 31, *Schmoll v. U. S.*, 63 Fed. Supp. 753 (Ct. of Claims, 1946), and *In Re Cummins Constr. Corp.*, 81 Fed. Supp. 193 (D. C. Md. 1948), the Court remarked that in its view the surety's rights had not been cut down by the *Munsey Trust* case, where the government's right of set-off was not involved, and wrote at pages 898-899:

> "It appears that these are correct interpretations of the *Munsey case*. Had the Court there intended to overrule the long line of cases grounded on *Prairie State Bank v. United States*, and *Henningsen v. United States Fidelity & Guaranty Co.*, both *supra*, it is reasonable to assume that they would have been more specifically referred to and discussed. Rather, they are inferentially reaffirmed where applicable facts exist, and the *Munsey* decision limited to its own peculiar facts where the Government's interest is more than that of a stakeholder".

In *Newark Insurance Co. v. U. S.*, 169 Fed. Supp. 955 (Ct. of Claims 1959), the government, after notice from the surety of its rights to the fund, paid the contract moneys to an assignee bank. The surety sued the government for a recovery of the money, and the Court denied the government's motion to dismiss, stating that if the government, with no rights of its own to assert to the fund, and in disregard of the asserted surety's rights, paid the money to the assignee bank, it might have to repay the money.

The government impleaded the assignee bank—Pioneer. The bank then moved to dismiss the government's claim over against it. The Court denied this motion and in its opinion on this branch of the case, 181 Fed. Supp. 246 (1960), wrote at page 248:

> "The Newark Insurance Company as surety was under bond to see that the terms of the contract were carried out. *It had first call on any funds necessary for this purpose.*" (Emphasis ours)

See also:

Gray v. Travelers Ind. Co., 280 Fed. (2d) 549 (C.A. 9 1960).

This paramount right of a surety to contract moneys, where it has paid losses under a payment bond, has been expressly recognized in the following cases, *where the contestant was the trustee in bankruptcy of the contractor:*

Continental Casualty Company v. U. S., 169 Fed. Supp. 945, 946-947 (Ct. of Claims 1959);

Pacific Indemnity Co. v. Grand Avenue State Bank of Dallas, 223 Fed. (2d) 513, 521 (CA 5 1955);

In Re Cummins Constr. Corp., 81 Fed Supp. 193, 196-197 (D. C. Md. 1948).

We respectfully submit that on the ground adopted by the District Court and the Court of Appeals, *viz.*, the surety's subrogation to the rights of the laborers and materialmen, whom it paid, or on the ground of its subrogation to the rights of the government, or upon the assignment given by the contractor, the surety is entitled to recover the fund here in question.

The result reached by the Court of Appeals, in the case at bar, we submit, was clearly right and is not in conflict with, or contrary to, this Court's decision in the *Munsey Trust* case. The views of the Ninth Circuit, in *Phoenix*

Indemnity Co. v. Earle, 218 Fed. (2d) 645 (1955), and those of the Tenth Circuit, in *American Surety Co. of New York v. Hinds*, 260 Fed. (2d) 366 (1958), we submit, have misconstrued, and are in conflict with, this Court's decision in the *Munsey Trust* case.

See in this connection, 71 Yale Law Riview 1274 (June 1962) "Reconsideration of Subrogative Rights of The Miller Act Payment Bond Surety".

In simple justice, the surety who paid for the labor and material bills, which in turn "produced" the fund, is far more equitably entitled to the fund than the trustee in bankruptcy, representing general creditors, who made no direct contribution to producing the fund.

POINT II

The bankrupt had "no property" in the unpaid contract funds here in question and, accordingly, the trustee has no interest or "property" in the $87,737.35 fund.

Under Point I of this brief we have discussed the surety's affirmative rights to the fund here involved. We should now like to briefly discuss the *absence* of the trustee's right to the fund. This is perhaps but the reverse side of the same coin, so to speak, and this Court, along with other Courts, has had, in recent years, this question before it, on several occasions. These cases clearly reveal the absence of any right in the trustee-petitioner to the fund here in suit.

Section 70 of the Bankruptcy Act (11 U. S. C. A. 110) provides that the trustee, upon his appointment and qualification shall, "* * * be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition * * *".

What title did the bankrupt contractor have to the fund here in question? We submit, it had no title to, or property in, the fund whatsoever. It had done certain work, to be sure, but it had also left behind it nearly $350,000.00 of unpaid bills which the surety had to pay and did pay. This was a clear breach of the contractor's obligation to the government under the payment bond which the contractor signed as principal. This in turn was a breach of its construction contract.

> *Martin v. National Surety Co., supra* (300 U. S. 588).

The Second Circuit, in *Fidelity & Deposit Co. v. New York City Housing Authority*, 241 Fed. (2d) 142 (1957) with reference to a public improvement contract with the New York City Housing Authority, held that where the contractor had earned unpaid contract moneys, but owed labor and material bills in excess of the earned but unpaid amount, the contractor had "no property" in those unpaid contract funds to which a federal tax lien against the contractor could attach, citing *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 297 N. Y. 31, 37 (1947).

The *New York City Housing Authority* case, *supra* (241 Fed. (2d) 142) was cited with approval by this Court in *United States v. Bess*, 357 U. S. 51, 55, 78 S. Ct. 1054, 1057 (1958), and also in *United States v. Durham Lumber Co.*, 363 U. S. 522, 526, 80 S. Ct. 1282, 1284 (1960).

In the case last cited, *Durham Lumber* (363 U. S. 522), this Court held that under North Carolina law, and in a factual setting similar to the case at bar, the contractor had "no property" in the fund to which a federal tax lien could attach. And, in *Aquilino v. United States*, 363 U. S.

509, 80 S. Ct. 1277 (1960) this Court held that if, under the New York law, the contractor had "no property" in the contract funds, there was nothing to which the federal tax lien against the contractor could attach. On remand to the New York Court of Appeals of the State of New York, that Court, in 10 N. Y. (2d) 271 (1961) held the contractor had "no property" in the fund.

To the same effect are:

Wolverine Insurance Co. v. Phillips, 165 Fed. Supp. 335 (D. C. Iowa 1958), which involved a private improvement contract in Iowa:

Central Surety & Insurance Corp. v. Martin Infante Co., 272 Fed. (2d) 231 (C. A. 3 1959), which involved a public improvement contract in New Jersey.

It is true that the foregoing cases all deal with property rights, or lack of them, under State law. However, under the federal contract cases we have cited the result would be the same.

In the only case we have found bearing *directly* on this question, *viz.*, *F. Burack Inc. v. Raymar Contracting Corp.*, 32 Misc. (2d) 75, 223 N. Y. S. (2d) 750 (N. Y. 1961), the New York Special Term held that earned contract moneys arising on a federal job situate in New York State, and *where the rights of the United States Government were not involved*, were subject to the trust provisions of the New York Lien Law (Art. 3-A—Lien Law—McKinney's Consolidated Laws).

The situs of the work embraced within the bankrupt's prime contract was New York State (the St. Lawrence Seaway). If resort need be had to New York Law the *Aquilino* case, 363 U. S. 509, and on remand to the Court

of Appeals, 10 N. Y. (2d) 271, would seem to be the complete answer.

In addition, it must be recalled that long prior to bankruptcy the contractor-bankrupt assigned to the surety-respondent, all its rights to the unpaid contract moneys. The assignment became operative the day the bond was executed, *viz.*, April 11, 1955, and accordingly on August 30, 1956, when the contractor became bankrupt, it had "no property" in the contract funds to be passed on to the trustee, the petitioner herein.

The bond was not for the *protection* of the contractor, but rather for the protection of the *contractor's job creditors.* The surety has paid the job creditors. As between the contractor (here represented by the trustee) and the respondent-surety, there are and can be no rights here present *in favor* of the contractor (or the contractor's representative, the trustee) *against the surety.* The obligations run in just the opposite direction—in *favor* of the surety *against the contractor* (and the contractor's representative, the trustee). This is basic in the law of suretyship.

The statutory beneficiaries of the promise made to the United States in the payment bond were the laborers and materialmen of the contractor (bankrupt) on the bonded contract only—*not his general creditors.* Both the trustee and the *amicus* brief of Streeter misconceive this basic relationship.

It must be borne in mind that the trustee expended no money from the bankrupt's estate for the purposes of the prime contract out of which the fund here in issue arose. None of the free assets of the bankrupt's estate have been used for the completion of, or the payment of, labor and ma-

terial bills arising from the prime contract. The trustee and the general creditors represented by him, accordingly, have no equitable claim on the conscience of this Court: they seek only a windfall.

See: 25 Fordham Law Review 241 (1956).

POINT III

The petitioner's brief and the authorities cited therein.

There remains for discussion the petitioner's brief and the authorities cited thereon.

The principal authority relied upon by the trustee is *American Surety Co. of New York v. Hinds*, 260 Fed. (2d) 366 (Tenth Circuit 1958).

In that case the surety's principal was the prime contractor on a Miller act job. The contractor went into bankruptcy.

At that time:

1) 94.86% of the work was completed.
2) $10,145.34 had been earned but was unpaid.
3) Unpaid material bills $15,000.00.

The trustee completed unfinished work at a cost of $994.79.

The government, after various offsets, paid the trustee $7,875.90.

The surety sought an order requiring the trustee to pay over to it the $7,875.90, less the trustee's cost of completing the contract.

Both the District Court and the Tenth Circuit denied surety's application.

The Court's Opinion, at page 368, stated:

1) "Having paid the laborers and materialmen, appellant (surety) may claim subrogation to their rights. But since laborers and materialmen have no enforceable rights against the United States the surety can rise no higher than the basis of the subrogation.

2) It would seem clear that if the surety can claim no enforceable right of subrogation through the creditors paid *and can assert no equitable claim to the fund itself, either in its own right or through the United States*, then the Trustee must here prevail * * *" (Emphasis ours).

We submit that the Tenth Circuit in the *Hinds* case failed to recognize the true equities. Had the surety-respondent not written the payment bond there would have been no source of payment of the labor and material claims. *The fruit of the laborers' and materialmen's efforts created the fund here in question. Had they not expended their labor and materials there would have been no fund to dispose of.* The surety, pursuant to its obligation under the payment bond, paid and discharged those claims—all of them. In equity and simple justice it is entitled to have the fund awarded to it. This consideration, we urge, was completely overlooked or misconceived by the Tenth Circuit in the *Hinds* case.

We respectfully urge that the Tenth Circuit's Decision in the *Hinds* case is contrary to the overwhelming weight of authority and is wrong. It flies in the face of the principle of the *Henningsen* case (208 U. S. 404), and the cases which have followed it. It completely overlooks the principle of law that when the surety pays labor and material bills it becomes subrogated to the rights of the owner to the contract funds. It does, to be sure, become subrogated to the rights of those whose claims it paid; but

that is not all the surety secures by such payment! In addition, it becomes subrogated to the rights of the *owner* to the contract funds! This right is clearly indicated by the *Continental Casualty* case (169 Fed. Supp. 945, and in the *National Surety Corp.* case (133 Fed. Supp. 381), both previously discussed.

It is interesting to note that in the *Hinds* case the Judges were Lewis, who wrote the Opinion, and Judges Bratton and Huxman.

In a later case before the same Court, *viz., U. S. v. Chapman*, 281 Fed. (2d) 862, Judges Bratton, Lewis and Breitenstein sitting, we submit, the doctrine of the *Hinds* case was overruled and repudiated, although the *Hinds* case was never mentioned!

The *Hinds* case proceeds, of necessity, on the theory that the contractor had an interest in the unpaid contract moneys which passed to his trustee in bankruptcy. In this later case by the same Court, the "no property" theory of the other cases we have cited was adopted.

In the *Chapman* case (281 Fed. (2d) 862) one Sims was the general contractor for Bell Telephone Company. Upon *completion of the work* Sims: 1) left unpaid labor and material bills of $20,151.75; 2) made assignments of unpaid contract balances of $11,697.66 to a finance company, as security for loans.

The government held unpaid tax liens of $24,000.00.

The Court, in the *Chapman* case, after referring to *Aquilino v. United States*, 363 U. S. 509, 80 S. Ct. 1277, and *United States v. Durham Lumber Co.*, 363 U. S. 522, 80 S. Ct. 1282, wrote at pages 866-867:

> "Sims * * * could not compel the Telephone Company to pay the retained percentage to him because of his failure to pay the laborers and materialmen. * * *
>
> The right to property which the United States asserts is covered by its lien is the right of Sims to compel payment by the Telephone Company. * * * That right does not exist because of the failure to pay the labor and material claims. * * *
>
> As the contractor-taxpayer had no enforceable right to the money covered by the retained percentage, there was no property or right to property to which the tax lien of the United States attached, except to the extent that the retained percentage exceeded the labor and material claims. * * *
>
> Following a long line of federal decisions, Oklahoma has held that *laborers and materialmen have an equitable right to payment from funds due a contractor on a public improvement in preference to general creditors* and that when a surety pays such claims it is *subrogated to the rights of the laborers and materialmen* and its right to recover from the fund takes precedence over an assignment of the fund by the contractor". (Emphasis ours).

The other case relied upon by the petitioner, in addition to those we have already discussed, is *Phoenix Indemnity Co. v. Earle*, 218 Fed. (2d) 645 (Ninth Circuit 1955). In that case the contest over contract moneys was between the surety, who had paid claims under a payment bond of a bankrupt contractor, and a tax lien fully perfected before bankruptcy against the contractor. The Court awarded the fund to the government.

The Court relied upon certain *dictum* of this Court in the *Munsey Trust* case (332 U. S. 234) as is apparent from page 649 of the Court's Opinion.

We respectfully urge that in view of the decisions of this Court in the *Durham Lumber Company* case (363 U. S.

522) and in the *Aquilino* case (363 U. S. 509), the *Phoenix Indemnity* case (218 Fed. (2d) 645) has, in effect, been overruled.

At page 13 of petitioner's brief the case of *Massachusetts Bonding & Insurance Company v. State of New York*, 259 Fed. (2d) 33 (C. A. 2 1958) is cited. That case had two (2) distinct branches—one involved an attempt by the surety to assert the government's priority with respect to a set-off exercised prior to bankruptcy in opposition to a further unpaid federal tax lien sought to be paid out of the bankrupt's *general assets*. The surety was unsuccessful in that branch of the case. The second branch of the case involved *contract moneys* diverted by the bankrupt prior to bankruptcy and invested in real property on which the surety sought to impress a lien prior to bankruptcy, the funds from which finally came into the hands of the trustee as traced funds. Here, the surety was successful.

Petitioner seeks to urge that the portion of the *Massachusetts Bonding* case, *supra*, (259 Fed. (2d) 33) cited, which involved a question of sharing the admitted *general assets* of the bankrupt, is authority in the case at bar, where the *only* fund involved is exclusively earned *contract money*. The two (2) branches of the case are radically different. The first branch is not in point. The second branch of the case fully supports the respondent's position here.

Conclusion

We respectfully urge that the Court of Appeals was clearly right in its determination, tracing, as it did, the surety's rights under the payment bond back to the *Henningsen* case (208 U. S. 404); and that its views that the *Munsey Trust* case (332 U. S. 234), did not cut down or

modify the surety's right in the case at bar, were clearly right.

We respectfully urge that the surety, in the case at bar, by paying *all the claims of the laborers and materialmen*, became subrogated to the rights of the Corps of Engineers (U. S. Government) in and to the fund, which are superior and paramount to any claims of the trustee, representing general creditors of the bankrupt for obligations not connected with the prime contract from which the fund here in issue arose.

We also urge that the surety's position, as subrogee of the claims of the laborers and materialmen, which it paid, comes ahead of the claims of the trustee.

Likewise the surety is entitled to recover by virtue of the assignment.

And, finally, we submit, the trustee has "no property" in the fund whatsoever, both by operation of law and also by virtue of the contractor's assignment to the respondent more than a year prior to bankruptcy.

POINT IV

The determination of the Court of Appeals should be affirmed and the fund ordered turned over to the respondent.

Respectfully submitted,

MARK N. TURNER,
Attorney for Respondent.
Office & P. O. Address,
440 M & T Building,
Buffalo 2, New York.

I Hereby Certify that I have served a copy of the foregoing brief on Raymond T. Miles, Esq., 942 Ellicott Square, Buffalo 3, New York, petitioner's counsel of record, and John G. Street, Jr., *amicus curiae*, 625 Fort Worth National Bank Building, Fort Worth, Texas, by depositing a copy of the same in a United States mail box, postage prepaid, addressed to each of the above counsel, at the post-office addresses set forth above, on September 12, 1962.

MARK N. TURNER,
Counsel for Respondent.

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner.

vs.

RELIANCE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

RAYMOND T. MILES,
LOWELL GROSSE,
Attorneys for Chester A. Pearlman, Trustee in Bankruptcy of Dutcher Construction Corporation,
942 Ellicott Square Building,
Buffalo 3, New York.

BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

INDEX.

Cases Cited.

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner,

vs.

RELIANCE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR THE PETITIONER

The petitioner's brief fully expresses its approval and reliance upon:

1. *United States v. Munsey Trust Co.*, (1947), 332 U. S. 234, 91 L. Ed. 2022.
2. *American Surety Co. v. Oscar Hinds, Trustee* (C. A. 10), 1958, 260 Fed. 2d 366.
3. *Phoenix Indemnity Co. v. Hugh A. Earle* (C. A. 9), 1955, 218 Fed. 2d 645.

However in view of the arguments made by the respondent in its brief, the petitioner takes this opportunity to re-

fer to those arguments and show how they are inapplicable to this lawsuit. It is our purpose in this brief to affirmatively expose to this Court the legal justification of the results in the case of *Henningson v. United States Fidelity & Guaranty Company*, 208 U. S. 404 (1908) and those cases which have followed it by a candid discussion of the cases which respondent, the Circuit Court of Appeals for the Second Circuit, and the District Court wholly depend upon.

In the public contract field the Government merely exacts from the contractor the requirement that the job be timely and satisfactorily performed, without consideration of laborer's and materialmen's payment as an element thereof. It need not be concerned with the possibility of mechanics liens for it is immune from such. In fact, the Government divests itself of all concern in this regard in two ways: Primarily, it does not contract to pay out of pocket the expenses of providing labor and material if the contractor should not. Indeed, the contract, both old and new, is quite clear in this regard. Second, whatever considerations of fairness and equity the Government might have felt toward such claimants were reflected and satisfied in the passage of the Heard and now Miller Acts.

However, in 1908 this Court rendered its opinion in *Henningson v. United States Fidelity & Guaranty Company*, 208 U. S. 404, and thereby created confusion and misunderstanding which multiplied with the cases which followed it. Though the surety's adversary therein was a bank which had lent funds to a contractor, the principles of subrogation set forth would seem analogous to the situation presently before this Court. In that opinion, Mr. Justice Brewer, speaking for the Court, at page 410 said:

> Is its (the surety's) equity superior to that of one who simply loaned money to the contractor, to be used as he saw fit, either in the performance of his building con-

> tract or in any other way? We think it is, it paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and supplymen were paid.

The Court found for the surety, apparently asserting it was subrogated to the position of the Government. The only authority textually relied upon by the Court was *Prairie State National Bank v. United States* (164 U. S. 227).

We contend that *Henningson,* though handed down over forty years ago and followed without discussion or rational analysis since then, is unfounded, both as a matter of logic and precedent.

The *Prairie* case was a performance bond case. We do not dispute that a surety is properly subrogated to the legal rights of the Government in such a case, for it is clear that the surety does satisfy a debt which is owed the Government by the contractor, and, thus, may step into the shoes of the Government, the one who it has benefited, asserting whatever rights the Government could assert. It is clear that the Government may use the retainages to complete performance. The contract so provides. Indeed, as this Court in *Munsey* pointed out, this is the only motive the Government has in retaining the percentages. Thus, a perfect example of the proper application of the subrogation doctrine is made out.

But, the conceptual difference between the respective rights of the parties in a performance bond case and a payment bond case indicates most strongly that the two are not similar; in fact, they are not even analogous. Restating our earlier discussion, the Government does not

contractually owe the laborers and materialmen anything; the Government does not by operation of law owe the laborers and materialmen anything. It, as an entity with a conscience, merely must observe its wish for fairness and equity. But, this is not a legal obligation in any sense of the word; notwithstanding, the Government, in pursuit of its sense of equity, provided for the protection of laborers and materialmen—made it necessary that a surety company exercising its commercial judgment under the experienced hand of actuaries, provide a bond for their protection. If any equity was present, the Government has discharged it.

Henningson is unsatisfactory in another, most basic respect. Equity has provided two vehicles—subrogation and reimbursement—to the ~~end of~~ having he, who in good conscience should pay another, make such payment. The Court in *Henningson* seems to have confused these doctrines and, in its confusion, misinterpreted their intended application. These vehicles were intended to protect a surety, whether commercial or private, where it pays a debt for which another is *PRIMARILY* liable. If the Government is an obligor, as *Henningson* seems to say, it is only an equitable obligor; that is, one who may have a moral duty to satisfy an obligation which it may discretionarily observe; but it is not an obligation which the Government must, under the compulsion of the law, satisfy. Certainly, the Government is in no way a PRIMARY OBLIGOR. Thus, whether the Court meant to say that the surety had a direct right against the Government for reimbursement to the extent of the funds in its possession, or indicated that the surety had a right to such funds by way of subrogation to the discretionary right of the Government to observe its moral obligation, it should not have stated it in terms of the equitable devices of subrogation

or reimbursement. The concept simply does not fit the situation present.

Nowhere in *Henningson* does the Court mention subrogation to the rights of laborers and materialmen by the surety. In fact, after quickly noting that the bank has no such right, it passed the subject completely and dwelt on *Prairie* as its sole ground of decision.

Yet, another case, *Belknap Hardware & Manufacturing Company v. Ohio River Contract Company*, (1921) 271 Fed. 144, gratuitously provided such an interpretation of *Henningson*. The Circuit Court of Appeals for the Sixth Circuit, speaking in 1921, commented on *Henningson*, at page 148:

> In that case, the surety upon a bond of this kind * * * and who had been compelled to pay its surety obligation, was held entitled to priority in the fund as against a general creditor of the contractor. The case was *essentially different* from the Prairie State Bank Case, because there the surety had taken over and completed the contract and the performance of the contractor's obligation to the United States as the other party to the contract, and so had become entitled to the security which the United States held against the contractor; in the Henningson Case, the contractor had completely performed the contract and had finished the work. It would seem, therefore, that subrogation in the Henningson Case could not be to any security which the United States held against the contractor; there was no such element in the case.

Such statement if left to stand alone, would be in full agreement with our formerly stated contention; that is *Henningson* did say that, *Henningson* did depend in its entirety upon *Prairie State Bank*, and therefore, Henningson, both as a matter of precedent and logic, must be overruled.

However, as many courts are wont to do in order to save the surety, *Belknap* went on, at page 148, saying,

> (In Henningson) The surety's claim of priority in the fund was sustained, and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated. This is not stated in the opinion in very express terms, but it had been pressed upon the court (cites omitted) that there could be no subrogation without such a right, and that there was no such right.

The inferences build upon each other, and the opinion totters, for the necessary corollary of an equitable obligation is not a legally enforceable right. Certainly, if one morally owes to another something, the other can assert that it should or ought to be paid. But, it is quite another thing to equate "oughtness" with "absolute obligation." Though the *Belknap* Court said that the laborers and materialmen have a "continuing equitable priority" in the fund—symbolically synonomous with "oughtness"—it held that such equitable priority is an absolute legal right.

This very Court, earlier in its opinion, recognized the weakness of its own position, by saying, at page 147:

> It is commonly held that this lien or priority (Mechanics Lien) is wholly statutory, and we are not aware of any case * * * where, without the aid of any contract or statute, this vague equity of materialmen and laborers has been thought sufficient to put the owner of the property under obligation to see that they were paid before he settled with the contractor.

Moreover, the Court in the Belknap case evidenced its own misgivings when it said at page 149 of its opinion:

"Obviously, the retained fund is devoted to the payment for such labor and material as may be necessary to finish the work after the contractor defaults. Whether it is devoted to pay the contractor's debts of this class is a distinct question and the cited cases suggest to us some confusion of thought on the subject."

Again, nothing is clearer than the total absence of any contractual or statutory relationship between the owner—the Government—and the laborers and materialmen. The contract allows payment of all retainages upon timely and satisfactory performance by the contractor; indeed, it provides that after fifty per cent of the job is completed, no further retainages need be withheld. There is no federal statute permitting mechanics liens on federal structures; indeed, case law prohibits the imposition of such.

We contend that *Belknap*, as the birthplace of cases which extend *Henningson's* statement of "subrogation" or "reimbursement" to an "Equitable priority" or "equitable lien" on the fund, is in error, is internally inconsistent, and states an unfounded conclusion that a Governmental "equitable obligation" necessarily means laborers and materialmen have a legally enforceable "equitable priority" which is superior to the right of other claimants.

Other courts have sought to justify their position by stating that the enactment of the Heard Act, the predecessor of the Miller Act, was a "precursor of judicial recognition of an enforceable equitable right of unpaid furnishers of labor and materials" to funds held by the Government subsequent to completion of construction. But does a common law right, which under our system of jurisprudence is founded upon reason and precedent, spring from a legislative enactment where such enactment was prompted by the absence of any legal or equitable recourse. It would seem not.

The statutory bond was provided so that laborers and materialmen might share a similar degree of protection afforded those in the private field, but absent in the public field. The enactment recognized that the law did not and could not provide such protection. Congress could easily have amended the standard form of the Government contract by making the Government a guarantor of payment of laborers and materialmen by the contractor. This it did not do. Instead, it required a commercial surety to so guarantee the payment. In this context, how may a surety claim that, because the Government has required a surety to pay if the primary obligor does not pay, the Government is under any obligation. Again, the inferences build upon each other and the reasoning totters.

It is our contention that, whatever the bulk of case law, whatever the period of its existence, whatever the sophistication of the courts which have followed it, the line of authority which rests on *Henningson*, and ultimately, *Belknap* is in error and must be overruled.

The Court of Appeals for the Second Circuit rests squarely on the Henningson case and therefore its order and judgment must be reversed and the order of the Referee in Bankruptcy of June 9, 1961, be reinstated.

RAYMOND T. MILES,
Counsel for Petitioner.

September 26, 1962.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE DAVID MORGULAS IN SUPPORT OF RESPONDENT

DAVID MORGULAS,
Amicus Curiae, on Behalf of The Association of Casualty & Surety Companies,
No. 521 Fifth Avenue,
New York City.

INDEX

Authorities

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

BRIEF OF AMICUS CURIAE DAVID MORGULAS IN SUPPORT OF RESPONDENT

To the Honorable Supreme Court of the United States

The Interest of the Amicus Curiae

Your amicus curiae represents The Association of Casualty and Surety Companies, a non-profit trade association consisting of one hundred thirty-six capital stock companies, most of which write surety bonds nationally not only in connection with public works contracts and other surety bond requirements of the United States of America but also in connection with private, State and Municipal improvements contracts. The member companies of The Association write at least 85% of the annual volume of surety bonds written throughout the United States. A decision against the surety by this Court in the instant case will have

a profound bearing upon the long standing underwriting concepts and practices of The Association's member Companies and other surety bond underwriters and, as a necessary consequence, on both the number of bidders qualified by them on Federal contracts, and the overall cost of the work.

Preliminary Comment

This case involves the relative rights of a government contractor's Miller Act surety which has expended approximately $350,000. in payment of labor and material claims vis a vis a trustee in bankruptcy (representing the interests of general creditors of the contractor-bankrupt) in the retained balance of $87,737.35 on the bonded contract. Unlike the *Munsey Trust Case,* 332 U. S. 234, upon which the appellant trustee relies, this case does not involve any contest between the surety and the government's superior equity in such balance. The government has no present interest in such funds.

The court may take judicial notice of the genesis of the fund. It represents (at least until the 50% completion point), 10% of the monthly amounts claimed and allowed to the contractor for work (in essence labor and material) performed during the preceding months. (See Article 7 of GSA Standard Form 23A, General Provisions of Construction Contract.) In the instant case, the contractor in legal effect had physically performed the work but had left substantial bills for labor and material unpaid which the surety, because of the contractor's default in payment, satisfied completely under its payment bond obligation.

The sole question in this case is "Who is entitled to the retainage, the surety which met all the obligations of its bonds, on which it bound itself at the inception of the contract as required by Miller Act, or the trustee in bankruptcy representing general creditors of the contractor for debts unconnected with the government contract?".

THE ARGUMENT

POINT ONE

The rights of a Miller Act surety to contract balances have their origin in the surety's overriding equities.

The origin of the surety's right to reimbursement out of retained contract balances rests in part in contract and more basically in early judicial recognition of the all pervasive equitable nature of the surety's claim. Since the earliest of the relevant decisions in 1896 there has been a proliferation of rather technical discussions of subrogative rights, variations of contractual obligation and an attempt to apply more or less schematic methods in determining the surety's rights. Notwithstanding the specific rationale of each case, the decisions most generally are premised upon a conscious attempt to apply equitable doctrine.

The first of such decisions was the leading case of *Prairie State National Bank* v. *U. S.*, 164 U.S. 227, at page 233, when this Court said:

> "That a stipulation in a building contract for the retention, until the completion of the work, of a certain portion of a consideration, is as much

for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed; that it raises an equity in the surety in the fund to be created; and that a disregard of such stipulation by the voluntary act of the creditor operates to release the sureties, is amply sustained by authority."

See also: *National Surety Co.* v. *County Board of Education*, 15 F. 2d 993 (C.C.A. 4); *Ft. Worth Independent School District* v. *Aetna Casualty and Surety Co.*, 48 F. 2d 1 (C.C.A. 5), cert. den. 284 U.S. 645; *American Surety Co.* v. *Sampsell*, 327 U.S. 269.

The reason for this position becomes quite clear when it is realized what would happen if, instead of completing the contract in *Prairie State* the surety had elected simply to pay damages. In this latter event it would have been liable for no more than the difference between the amount paid by the owner for completion and the contract balance in the owner's hands at the time of completion. If, by sitting it out, the surety would receive the benefit of the contract balance, then clearly by actively "doing more" it should be in no worse position. See *Lacy* v. *Maryland Casualty Co.*, 32 F. 2d 48, 51 (4th Cir., 1929).

It must be remembered, in this connection, that at the time of *Prairie State*, "payment bond" obligations, if they existed at all, were written as part of the performance bond, as was the case under the Heard Act from the time of its enactment in 1894. The separation of the performance and payment covenants of the Heard Act bond into two distinct instruments by the Miller Act in 1935 was a pro-

cedural reform for the convenience of labor and material claimants and was not intended to enlarge the surety's liability. That such was the case was recognized by this court in *Clifford MacEvoy Co. v. U. S.*, 322 U.S. 102 (1944) and by Judge Medina in the opinion below. It is an interesting bit of history that as early as 1914, this court in *Equitable Surety Co., v. McMillan*, 234 U.S. 448, 454, 456, in ruling on the District of Columbia counterpart of the Heard Act and its bond form, explicitly approved federal and other state court holdings that the two agreements for performance of the contract and payment of labor and material contained in a single bond "are as distinct as if contained in separate instruments."

The same rationale supporting the surety's equity applies in the case of payment of labor and material bills under the payment bond; for if the surety were to refuse to pay such bills voluntarily and without suit during the progress of the work, the contractor would undoubtedly be forced to default. If the surety then undertook, or arranged for completion, it would in the capacity of a "performance" surety be paying the claims of subcontractors and labor and materialmen in order to keep the project moving to completion. Under such circumstances, even the Appellant concedes the surety's full right to any contract balance in the government's hands. This analysis demonstrates how unrealistic it is to attempt to make the surety's right to the retainage on the job turn on whether the obligations it satisfied were liabilities under its performance bond or under its payment bond. Insofar as the surety is concerned its payments are but the two sides of the same coin, the obligations it undertook as surety. The surety's payments came

from the same pocket because the performance bond and the payment bond surety *is always the same.* The surety executes both bonds as a package of coverage and the same indivisible premium pays for the whole package.

However, this simple, but realistic analysis has been obscured by the attempts to discover a doctrinal framework within which the strongly perceived equity of the surety could be sustained.

Henningsen v. *United States Fidelity & Guaranty Co.*, 208 U.S. 404 (1908), was the second recognition by this Court of the surety's priority but in a fact situation where the surety had expended monies under the "payment" covenant rather than the "performance" covenant of the bond. At the root of the decision, however, was the equitable right first perceived and declared in *Prairie State* (see 208 U.S. at 411) to which the *Henningsen* court referred in the following language (after stating that the merits turn "upon the respective equities of the parties"):

> "The guaranty company was surety on that contract. Its stipulation was not merely that the contractor should construct the buildings, but that he should pay promptly and in full all persons supplying labor and material in the prosecution of the work contracted for. He did not make this payment, and the guaranty company, as surety, was compelled to and did make the payment. Is its equity superior to that of one who simply loaned money to the contractor, to be by him used as he saw fit, either in the performance of his building contract or in any other way? We think it is. It paid the laborers and materialmen,

and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and supply men were paid. It did this not as a volunteer, but by reason of contract obligations entered into before the commencement of the work."

The difficulties which have arisen in the area of Federal contracts stem entirely from the not unnatural desire of the courts to rationalize decisions in doctrinal rather than equitable terms. But at the core of every decision in this area may be found a fundamental recognition of the surety's equitable right to the fund which has been, in fact, created by its very presence as guarantor (without which the contract could not even be awarded in the first instance), and secured by the fulfillment of its obligations to the labor and materialmen from whose contributions to the project the retained fund actually derives.

In point of fact, there is no distinction in this regard between a surety functioning as a "payment" surety and one actually completing physically uncompleted work under a performance bond. This point is illustrated in *Maryland Casualty Co. v. U. S.*, 100 C.Cls. 513, 521-2.

"The effect of the contract and the bonds is that the contractor promises the Government that it will build the structure, *and* will pay the laborers and materialmen. The Government takes two separate bonds to secure the fulfilment of these promises, since its interest in the first is

more physical and direct than in the second. But when the surety pays the laborers and materialmen it is performing the contract as much as when it completes the building."

This insistence on finding a "legal" rationale for what was without question an "equitable" result gave rise to many variations of the subrogation theme.

In *Farmers Bank* v. *Hayes et al.*, 58 F. 2d 34 (C.C.A. 6), the Court, holding for the surety, said:

"This is on the principle that a surety who gives bond to the owner to insure performance of a building contract by the contractor is subrogated to the rights of the *owner* in the percentage which the owner retains as security for the performance of the contract when upon default by the contractor the surety performs, as in the Prairie State Nat. Bank case, or on the principle that when the contractor performs his obligation to the owner, but fails to pay labor and material men, and the surety is obliged to do so under his bond the surety is subrogated to liens of laborers and materialmen upon the fund reserved by the owner."

"Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404; Belknap Hardware Manufacturing Company v. Ohio River Contract Company, 271 Fed. 144; Exchange State Bank v. Federal Surety Company, 28 Fed. (2d) 485 (C.C.A. 8)."

And in the case of *Richards Brick Co.* v. *Rothwell*, 18 App. D.C. 516, 537 (1901), the Court formulated

the rule, as applied to a payment bond situation, in the following manner:

"There is, therefore, by necessary implication, an equitable lien and preference secured in favor of the parties who furnish labor and materials in the execution of the contract, in the application or distribution of the contract price remaining to be paid; and where the government, as in the present instance, holds in its hands any part of the money contracted to be paid for the work, and there remain unpaid claims for labor and materials supplied, it holds such fund as quasi trustee for the benefit of those entitled to receive it under the condition in the bond; that is to say, the laborers and materialmen remaining unpaid. This right to preference being the result of the operation of the statute and the condition of the bond, it is the clear right, upon the plainest principles of justice, of the sureties in the bond to invoke a court of equity to enforce the preference and equitable lien for their protection. In construing this act of Congress of 13th August, 1894 [the Heard Act], this court said, in the case of Marble Company v. Burgdorf, 13 App. D. C. 506, 519 (1898):

'The practical effect of the statute is to confer a special lien in favor of such persons, (parties furnishing labor and materials) and to substitute the bond, in the place of the public building, as the thing upon which that lien is charged.'

"That is to say, the bond is liable rather than the building upon which labor and materials are used in construction; and if the sureties should

pay claims for such labor and materials for which they may be responsible on the bond, they have a right, upon well-settled principles, of substitution to such claims as against the contract price of the work remaining due to the contractor. And having such right of substitution, the sureties have a right to interpose to prevent the diversion or misapplication of the fund, and to require it to be paid out to the parties entitled to receive it in the first instance by virtue of the lien and preference given by operation of the statute."

It is to be noted that throughout the *relevant* decisions, of which the foregoing are only a small number, the terminology employed continues to shift—the words used are such as "special lien" "equitable priority"; "equtable lien", etc.—all of which merely formalize the underlying principle. See Jordan, "The Rights of a Surety upon the Default of Its Contractor Principal", 41 Oregon Law Rev. 1, 13.

The fundamental equities of the situation have been expressly recognized as controlling over technical constructions. In the case of *Massachusetts Bonding & Insurance Co. v. State of New York*, 259 F. 2d 33, a highly analogous factual situation was present. The surety paid out substantial sums to labor and materialmen to keep the contractor on the job so that it was actually completed before bankruptcy occurred. The Court cut through the technical arguments raised by the United States and State of New York, both of which were asserting tax liens, and said:

"The questions here are whether the bankrupt defaulted so as to bring into operation the rights of the surety, and if so, whether these rights to

payments from the owner take priority over tax claims of the State of New York and the United States. Both the State and the United States vehemently argue that the default contemplated in the contract between the bankrupt and the surety never occurred, and hence the assignment never matured; nor did the surety acquire a lien by way of subrogation. To some extent the arrangement created by the bankrupt and the surety whereby construction costs were paid out of the joint account into which they deposited progress payments supports this argument, for nominally the bankrupt continued its operations subject only to financial supervision by the surety. In this way construction activity never ceased and bills were paid without material delay. *But to analyze these facts so as to deprive the surety of its claim based on subrogation when it actually provided over $136,000 of its own money to pay laborers and materialmen is too technical to warrant serious consideration.* Cf. *Century Cement Mfg. Co. v. Fiore*, 264 App. Div. 475, 36 N.Y.S. 2d 332. The nub of the bankrupt's default was its inability to continue paying its bills. Whether the surety stepped in prior to or after the bankrupt failed to pay these bills is of little moment. The important fact is that the surety expended large sums of its own money to complete the contracts for which it has not been recompensed. (emphasis added).

POINT TWO

***American Surety Co.* v. *Hinds*, 260 F. 2d 366 (10 Cir. 1958) completely misconstrued both this Court's holding in *U. S.* v. *Munsey Trust Co.*, 332 U.S. 234 (1947) and the existing law governing the equities of a surety seeking reimbursement, and reached a totally erroneous conclusion.**

It was not until *American Surety Co.* v. *Hinds*, 260 F. 2d 366 that any court hurdled these and other long established equitable determinations and reached an opposite result by dint of a highly technical and, it is submitted, wholly incorrect application of a theory apparently suggested by, but by no means stated in *U. S.* v. *Munsey Trust Co.*, 332 U.S. 234 (1947).

Drawing upon the language in *Munsey*, which was directed towards a totally different problem where the government was not a stakeholder and had asserted a superior equity, the *Hinds* Court waved aside those distinguishing features in the two cases—the very ones which this Court emphasized as differentiating *Munsey* from any other case previously before it for decision.

The Tenth Circuit overlooked that *Munsey* represented a fact situation where the normal and traditional equities of the surety in contract funds (discussed in Point One above) had been displaced by a superior equity (a right of offset) in the government by reason of its dual position as a debtor and a creditor of the contractor, a superior equity which was forti-

fied by the statutory power of the Court of Claims and by "logical implication" of the Comptroller General to settle accounts by and against the government. See *Munsey*, pages 239-240. Furthermore, the Tenth Circuit failed to perceive that under the facts in *Hinds* it was a non sequitur to hold that because the surety's equity in the *Munsey* situation was displaced by the paramount equity and statutory position of the government, that, therefore, the surety had no equitable right in the funds superior to those of complete strangers to the contract from which the funds in issue, and the surety's loss, arose. We respectfully submit that this Court should not countenance such an inequitable interpretation of its holding in *Munsey*.

Another deficiency in the position taken in *Hinds* lies in the Court's assumptions that the surety could assert "no equitable claim to the fund itself, either in its own right or through the United States".

Having just discussed our difficulties in understanding the court's illogical assumption as to the absence of the surety's right to the fund "in its own right", we now turn to its further assumption that there was no right assertable "through the United States". The Court entirely failed to discuss "Whether the contractor's failure to pay labor and material did not constitute a breach of contract with the United States?" This facet of the surety's right to the funds arises from the contract documents when viewed as a whole and was marked out by Mr. Justice Cardozo in *Martin v. National Surety Co.*, 300 U.S. 588, discussed below.

The Miller Act, 40 U.S.C. 270 a-d, requires as a condition precedent to the award of any contract that

a payment bond in the statutory sum be furnished. By the specific language of the bond (GSA Standard Form 25A), the contractor engages to the government that all labor and materials shall be paid. This promise, being simultaneously effective with and required as a condition precedent to the award of the contract, is an integral part of that contract. Thus a failure by the contractor to pay labor and material bills is, quite specifically, a breach of his contract with the government.

This court so held in the case of *Martin* v. *National Surety Co.*, 300 U.S. 588 at p. 597:

> "But the statute directs that a bond for the prompt payment of materialmen and laborers shall be executed by the contractor before the commencement of the work. Not only that, but the contract with the Government, which was drawn in the standard form is a confirmation and adoption of the statutory duty. *The terms of the bond are read into the contract, and there is a default under the contract when there is default under the bond.*" (597-8). (emphasis added)

Thus, even if we follow the language and reasoning of the Court in *Hinds* to the effect that retained percentages are held by the government only to insure "performance" of the contract, we must reach the same result—for payment of labor and materials is as much an element of performance, by virtue of the promise made in the bond, as though it were spelled out in the contract itself. And once the government's right to invoke a breach for non-payment has been obviated by the surety's action, the surety is entitled, by "subrogation" to the same right the government

had to use the retainages to ensure performance. Cf. *U.S.F. & G. Co. v. Triborough Bridge*, 297 N.Y. 31; *Aetna Casualty & Surety Co. v. Horticultural Service*, 4 N.Y. 2d 639.

Furthermore, as a result of such breach, the contractor has no property right in the unpaid balances which can be claimed by the trustee standing in his shoes. *F. H. McGraw Co. v. Sherman Plastering Company*, 60 F. Supp. 504; *U. S. Fid. & Guar. Co. v. U. S.*, 92 C. Cls. 144; *Martin v. National Surety Co.*, 300 U.S. 588; *In re Duncan*, 127 F.2d 640 (CCA 3); *Karno-Smith v. Maloney*, 112 F.2d 690 (CCA 3).

A word about *Phoenix Indem. Co. v. Earle*, 218 F.2d 645 (9th Cir. 1955), which is also relied on by the Appellant. Firstly, the case involved the status of the United States as a tax lienor vis a vis the surety. As such the government enjoyed all the advantages of its tax status as against a so-called "imperfected lien". Secondly, and most importantly, the fact situation in the case (page 648) plainly shows that on July 29, 1951, the Collector of Internal Revenue filed a proof of claim in bankruptcy based upon previously filed liens in the amount of $12,486. The Collector, however, failed to notify the Bonneville Power Administration (an agency of the United States) of the existence of the offset claim and, thus uninformed, the Administration on January 18, 1952 proceeded to pay to the trustee in bankruptcy the sum of $11,838.61. Had the Administration been aware of the offset, it could and would have enforced it with complete impunity under *Munsey* and other decisions of the Court. (See e.g., *Cherry Cotton Mills v. U. S.*, 327 U.S. 536.) Thus in reaching its decision the Ninth Circuit was simply following the classic equitable

doctrine of "regarding as done what should have been done". Considered in this light, *Phoenix* can have no application whatever to the problems presented in the instant case.

POINT THREE

Retainages are held by the Government not only to ensure "performance" in the sense the term is used by the *Hinds* Court, but to ensure payment as well. Payment is an inextricable element of performance, and the economic benefits derived by the Government from the payment bond are as important as physical completion.

Assuming, arguendo, that a failure to pay labor and material bills was not actually a breach of contract (compare, *Martin* v. *National Surety*), the result must in any event be the same. The Court in *Hinds* not only overlooked the breach of contract principle of the *Martin* case but also proceeded on the incorrect assumption that the Government derived no direct benefit from the presence of the payment bond. Therefore, the court dubiously concluded, the retained percentages were held *solely* to protect the Government's interest in performance of the contract and, by subrogation, to provide reimbursement for the surety completing physical "performance" of the contract work under its performance bond but not for payments made pursuant to its payment bond.

The existence of considerable economic benefits derived by the Government from the payment bond negates so limited an assumption. Principal among

these benefits is a general lowering of subcontractor and material bid prices as a result of the bond's assurance that payment will be made and the consequent lack of incentive to "weight" or "hedge" prices against dubious credit risks. This point was made by this Court in *Equitable Surety Company v. McMillan*, 234 U.S. 448 at p. 456:

> "The public is concerned not merely because laborers and materialmen (being without the benefit of a mechanic's lien in the case of public buildings) would otherwise be subject to great losses at the hands of insolvent or dishonest contractors, but also because the security afforded by the bond has a substantial tendency to lower the prices at which labor and material will be furnished, because of the assurance that the claims will be paid."

See also Cushman, Surety Bonds on Public Construction Projects, 46 A.B.A.J. 649.

In a highly relevant article in 27 Fordham Law Review (1958), p. 262 at 270-71, the following analysis appears:

> "To ascribe to the public corporation wholly unselfish motives in exacting the payment bond, is to ignore commercial realities. The possibility of a lien may be only one of the motives for exacting a payment bond. There are other motives, common to both a private party and to a governmental unit. First, the reduction in expense for credit investigation and bad debt losses, not only making it possible for the subcontractor or materialman to charge a lower price, but also

inducing competition by subcontractors and materialmen who might not otherwise wish to compete with a consequent lower bid by the contractor. Second, the assurance of steady progress of the work in the case of default by the contractor, since unpaid laborers and materialmen can look to the bond for compensation. Third, the avoidance of the annoyance and risk of withholding payments to the contractor in favor of unpaid laborers and materialmen should the contractor default. Even without the possibility of a lien, these commercial advantages seem motive enough for the owner to insist on a payment bond from the contractor."

See also Reconsideration of Subrogative Rights of The Miller Act Payment Bond Surety, 71 Yale Law Journal 1274, 1279, n. 28.

Thus to say that the only purpose for which the Government holds the 10% contract retainer and any relevant contract balance is solely to ensure completion of the contract on time and to predicate thereon a denial of the rights of an out-of-pocket surety on a payment bond is simply to deny the economic realities of the problem. Inasmuch as the property of the sovereign is immune from mechanic's liens and similarly immune from any form of suit on implied contract by subcontractors, some substantial security must be offered to subcontractors and material suppliers to induce their participation in public work. Therefore, the government has since 1894 required that they be afforded bond protection. The premiums for such bonds form a part of the bid price on all such contracts and, although the contractor is required to

furnish the bond, the government is in reality, as we have seen above, subserving more than a moral obligation to labor and material when it in effect purchases protection for them and for itself. Without such protection it is highly doubtful that any kind of truly competitive pricing could be achieved on government work as prudent subcontractors and materialmen, of necessity, would hedge their bids against the possibility of non-payment by government contractors and government contracting officers would have no objective assurance that the successful bidder was "responsible".

Simultaneously with the payment bond, the government also requires a performance bond, thus assuring itself of completion within a fixed and predetermined cost (the contract price). If subcontractors, labor and materialmen, are not paid promptly, it is reasonable to expect that they will refuse to progress the job and thereby precipitate the general contractor's default. If the government's interest in completion "on time" is to be served, it is performance under both the "payment" and the "performance" bond which will best serve its needs. Thus, in point of fact, the "payment" bond is required to buttress one of the basic obligations of the contractor's performance, i. e., *timely* completion.

And what of the retained percentages? Surely if these funds are held by this court as against general creditors of the contractor to be unavailable to the surety for reimbursement, the surety has nothing to look to and has no interest in performing under the "payment" bond. Rather, it will have a strong financial incentive to stand by and allow a shaky con-

tractor to default and then take over performance of the contract itself, thereby assuring itself of recourse to the contract balance. The Surety should not be forced into such a procedure since in the role of a "performance" surety, it merely pays for the very same labor and material it would otherwise have to pay as a "payment" surety. Thus while ultimate physical completion may still be assured, the Government has lost the element of timeliness which may be of equal or greater importance than physical completion alone. All of which is to say that the two obligations of the surety are so intertwined as to become one in any practical sense. This relationship justifies the *Henningsen* Court's declaration at page 410 of the Official Report that *Prairie State* "is in point."

POINT FOUR

The ultimate availability of the "contract balance" as salvage is of great importance to sureties and to the Government.

A fundamental error is too often made in regarding the surety on the construction bond as an insurer and thus subject to the law of insurance and its concepts. No mistake could be more detrimental to a clear understanding of the surety's position in the construction industry and in the business world generally.

A surety bond affords no protection whatsoever to the principal himself. This has been overlooked by

the Appellant and the Amicus Street when they talk as if the bankrupt-principal had purchased some kind of insurance coverage protecting him and his general creditors. One of the deeply rooted and historical rights of a surety is to be indemnified or exonerated by its principal for all losses caused it by such principal's act, default or miscarriage. From these long recognized rights of a surety and from long recognized subrogatory rights, very substantial salvage flows to the surety.

The *Prairie State* and the *Henningsen Cases* in this Court, discussed above, were early affirmations of the surety's rights to salvage the contract balance as against strangers to the surety's obligation.

Corporate sureties were first permitted to be accepted as surties on bonds running to the Federal government in 1894, on the very same day when the Heard Act was enacted. (See Title 6 U.S.C. sec. 6 and repealed section 270 of Title 40). The doctrines established by *Prairie State* in 1896 and *Henningsen* in 1908 were widely followed by the lower federal courts and substantially all state courts. The salvage rights deriving from these cases became the warp and woof of the surety underwriter's analysis of the risk and have been relied on to date.

Professor Jules Backman in his "Surety Rate-Making" on page 34, pointed up the importance of salvage to the surety:

> "Surety Premiums Are Not Primarily Contributions To a Fund Out of Which Losses Are Paid. Salvage is Significant In Suretyship. With

insurance there is substituted a certain loss (the cost of the premium) for an uncertain loss (the hazard to which the insured is subject). Thus, with fire insurance the cost is the premium, not the much larger but indefinite cost attending a fire. Again, with automobile insurance the cost is the premium, not the uncertain damages resulting from an accident. For these types of insurance, as well as others, the policyholder's cost is the premium and no more, except in very unusual cases.

Suretyship presents a marked contrast. The payment of the premium by the principal, is in addition to any loss he may suffer from the transaction bonded. The bond does not relieve the principal of his obligation. The surety bond relieves the fears of the obligee—the person to whom, or organization to which a loss must be paid if the principal's obligation is not fulfilled. If a loss does occur and the principal cannot meet it, then the surety makes good. But in effect the surety company often is merely telescoping time. It pays today, with the full right to recover from the principal tomorrow. In the vast majority of cases, the principal meets his obligation or makes good the financial obligation he incurs so that the surety company pays no losses. But even where the surety company must make the payment, it may recover all or a substantial part of its loss payments and claim expenses. Indeed, as indicated in Chapter III, approximately one-third of the losses paid on surety bonds in the past has been recovered through salvage. For insurance lines, on the

other hand, salvage is non-existent or an insignificant factor."

The importance of salvage to the surety was even earlier recognized by Mr. Crist in his "Corporate Suretyship" (1st ed. 1939) on page 136. Another recognition of its importance is to be found in chapter 8.03-.04 of the "Handbook of Architectural Practice" (8th ed., published by the American Institute of Architects in 1958).

It is significant fact that notwithstanding that the contract balances have been available to the surety for purposes of salvage for many years under the decisions of this court, the statistics filed by The Surety Association of America with the various insurance departments of the United States and with the insurance department of the District of Columbia indicate that the loss experience on federal contract work has been considerably worse than on similar non federal work. This undoubtedly is a product of the liberality with which the Miller Act has been construed by this Court and the lower federal courts.

The following statistics are drawn from the yearly figures filed in the various insurance departments, as mentioned above, and have been tabulated by The Surety Association of America. Extracts from these tabulations were published in 71 Yale Law Journal 1274, 1279 n. 26. (The ratio of "loss" costs shown below are in addition to the sureties' expense ratio for "federal taxes" and "other expenses", such as "commission and brokerage expense", "operating expense", "unallocated loss adjustment expense", and "[other] taxes, licenses, and fees". The technical

content of each of these terms can be found in the Regulations on "Uniform Accounting" of the National Association of Insurance Commissioners).

FEDERAL CONTRACT EXPERIENCE —
COUNTRYWIDE U.S.A. —
NET DIRECT BUSINESS — ALL COMPANIES

Calendar Year	Net Premiums Written	Net Losses Incurred	Ratio
1946	$ 5,749,927	$ 56,246	1.0
47	6,859,168	32,893Cr	0.5Cr
48	8,980,178	425,072	4.7
49	10,082,976	1,742,074	17.3
50	10,411,277	1,945,103	18.8
51	21,124,877	5,746,698	27.2
52	21,431,462	5,369,537	25.1
53	16,125,444	8,497,871	52.7
54	14,381,336	9,505,795	66.1
55	16,417,365	9,252,341	56.4
56	16,303,032	10,275,393	63.0
57	18,584,549	8,911,485	48.0
58	22,672,413	9,799,656	43.2
59	18,481,918	11,886,736	64.3
60	18,275,155	15,579,859	85.3
Total Last 5 Yrs.	94,317,066	56,453,129	59.8
Total 15 Yrs. 1946-1960	$225,872,077	$98,960,974	43.8

NON-FEDERAL CONTRACT EXPERIENCE—
COUNTRYWIDE U.S.A.—
NET DIRECT BUSINESS ALL COMPANIES

Calendar Year	Net Premiums Written	Net Losses Incurred	Ratio
1946	$ 16,563,102	$ 879,721	5.3
47	25,097,563	4,311,153	17.2
48	39,563,572	8,593,732	21.17
49	48,496,180	10,708,386	22.1
50	62,392,320	14,363,498	9.1
51	60,674,219	27,874,209	45.9
52	64,559,579	21,058,049	32.6
53	75,879,484	21,910,320	28.9
54	81,576,837	22,180,022	27:2
55	86,575,731	34,475,182	39.8
56	91,327,971	44,004,936	48.2
57	96,416,698	42,695,819	44.3
58	107,909,569	36,454,216	33.8
59	103,660,334	41,810,308	40.3
60	109,439,653	74,789,792	68.3
Total Last 5 yrs.	508,754,225	239,755,071	47.0
Total 15 Yrs. 1946-1960	$1,070,132,812	$406,106,343	37.9

If to such liberality of construction, this Court now adds another factor—the divorcement of the payment bond surety from its traditional salvage rights in the contract balances in favor of general creditors of bankrupt contractors, it is difficult to envisage what the overall loss experience of the surety industry will be. It will be faced with a condition in the underwriting of contractors on federal public works

for which it has had no broad precedent since the beginnings of corporate suretyship.

Several consequences may ensue:

1. Surety experience on federal contract bonds may necessitate a re-examination of the rate structure with a surcharge on federal contracts. Today the contract bond rate structure makes no distinction between federal and non federal public work contracts. The possibility of such a surcharge is not in the best interests of the United States. Why should it pay more for its necessary bond protection because general creditors who have no responsibility for the progressing of the federal work or the payment of labor or material bills shall have achieved 54 years after *Henningsen* a change of status as a result of a reversal of the Second Circuit in this case?

2. Some surety companies may deem it prudent to withdraw from across the board underwriting of contractors on federal public works contracts. This, too, is not in the interest of the United States. In recent years public works contracts of the United States have been growing larger and larger in size. Under the Regulations of those charged in government with the construction of federal public works such as the General Services Administration, the Corps of Engineers, the Bureau of Yards and Docks, performance bonds in 100% of the price, together with the statutory payment bond under the Miller Act are now widely required. Any withdrawal of surety company underwriting in the federal contract field would make it very difficult for the government to obtain the protection it seeks on

its giant contracts. On such jumbo contracts, wide spread co-suretyship is necessary among companies on the Treasury List of Approved Sureties who are limited in their participation to 10% of their capital and surplus as a maximum. (See sections 10, 11 and the Proviso of 12(a) of Treasury Department Circular 297 and Circular 570.) As a general rule, however, few companies on very large contracts participate in the co-suretyship to the maximum limit of their Treasury Department qualification. If such a narrowing of risk participation on federal contract bonds should occur, the government will lose the benefit of the experience and "know-how" of the surety industry in qualifying bidders, to say nothing of the financial security afforded by the bond.

3. Surety underwriters will undoubtedly tighten up their underwriting requirements for bidders on federal works. Since the unjust enrichment of the general creditors at the expense of the long recognized priority of the payment surety in the contract balance will seriously impair the surety's salvage recoveries, it is reasonable to anticipate that only those contractors of high financial strength will be able to meet the underwriter's tests for the risk before him. A necessary effect of this belt tightening will be that many bidders now meeting current underwriting requirements will no longer be able to do so with a corollary effect on the interests of the government—the base of available competitive bidders on federal public works will be narrowed. Such a contraction in the number of qualified competitive bidders in economic theory,

at least, will bring about a price level higher than that produced by wider based public bidding.

4. Finally, and auxiliary to the last point, destruction of the salvage rights of the surety in the contract balance will also set up through the operation of 3. above, a counterweight to the policy of government to achieve the widest distribution of public and other contract work among the "small business" community. Very few so called small business men will be able to qualify for surety bonds under conditions where the surety risk has been converted to an insurance risk.

It has been the policy of the Government to encourage and assist the participation of small business concerns on both prime and subcontracts. See 41 U.S.C.A. App. Rules and Regs. § 1-1.702 (Supp. 1961) which states the following:

> "(a) *General policy.* It is the policy of the Government to aid, counsel, assist, and protect, insofar as possible, the interests of small business concerns in order to preserve free competitive enterprise; and to place with small business concerns a fair proportion of the total Government purchases and contracts for property and services (including contracts for maintenance, repair, construction, and research and development).
>
> * * * *
>
> (b) (2) Small business concerns shall be afforded an equitable opportunity to compete for prime contracts and subcontracts."

Insofar as the construction industry is concerned a "small business concern" is defined as one whose "average annual receipts for the preceding three fiscal years do not exceed $7,500,000.00. [Title 41, 1-1.701-1 (a) (2) (i)] It is highly doubtful whether any contractor thus qualifying as a "small business" could put up the collateral or other indemnities that would be required by a surety which knew that it could not look to the contract balance in case of his default.

Both the Miller Act and the Heard Act before it had as one of their principal purposes the implementation of competitive bidding by broadening the base of available contractors on whom the Government might rely for public works with full assurance of fully-paid completion. In these days when the prevention of monopoly and the artificial narrowing of competition in any industry have become a matter of judicial as well as political concern, it becomes all the more important that the "competitive base" be not at all diminished, particularly where to do so would be to lead to increased costs.

POINT FIVE

All other considerations aside, the surety has a primary right to the fund by virtue of the assignment contained in the indemnity agreement between it and its principal.

In order to induce the surety to execute the Miller Act bond required by the statute, the contractor in the instant case long prior to his bankruptcy delivered to the surety a duly executed written assignment of all monies under the contract which the contractor

entered into with the United States. The pertinent part of this assignment reads as follows:

"5. If any such bond be given in connection with a contract, to assign, transfer and set over, and the Indemnitors do hereby assign, transfer and set over, to the Company, surety or sureties executing said bond or bonds, such assignment to become effective as of the date of said bond or bonds, but only in the event of any such abandonment, forfeiture or breach as aforesaid—

a. All their right, title and interest in and to all machinery, plant, tools and materials which are now or may hereafter be upon the site of the work embraced in such contract, or elsewhere for the purposes thereof, including all materials purchased or ordered for said contract, whether such materials be completely manufactured or not;

b. All their right, title and interest in and to any and all subcontracts let or which may be let in connection with such contract;

c. Any and all percentages of the contract price retained on account of said contract, and any and all sums that may be due under said contract at the time of such abandonment, forfeiture or breach, or that thereafter may become due;

d. All their rights in, and growing in any manner out of, said contract or said bond or bonds."

Such assignments have long been recognized as valid between the parties to the assignment. See

Martin v. *National Surety*, 300 U.S. 588; *U. S.* v. *Munsey Trust Co.*, 332 U.S. 234 (1947), p. 237, note 1. See also *Lacy* v. *Maryland Casualty Company*, 32 F. 2d 48 (CA 4, 1929) and *U. S.* v. *Aetna Casualty & Surety Co.*, 338 U.S. 366 (1949); 4 *Corbin*, Sections 869, 906.

It is thus quite clear that, by virtue of the assignment, the contractor had no rights in the retained balance to which the trustee could possibly succeed. See *National Surety Co.* v. *Lane*, 45 App. D. C. 776; *Philadelphia Bank* v. *McKinlay*, 72 F. 2d 89; *Moran* v. *Guardian Casualty Co.*, 76 F. 2d 438; *California Bank* v. *U.S. Fidelity & Guaranty Co.*, 129 F. 2d 751; *Lyttle* v. *National Surety Co.*, 44 App. D. C. 1936; cf. *Alabama-Tennessee Natural Gas Co.* v. *Lehman-Hoge & Scott*, 122 F. Supp. 314 (N. D. Ala. 1954); *In re Allied Products Co.*, 134 F. 2d 725 (6th Cir.), cert. den. 320 U.S. 740 (1943); *Salem Trust Co.* v. *Manufacturer's Finance Co.*, 264 U.S. 182 (1924).

Further, and perhaps of even greater importance, as a result of its failure to pay labor and material bills, the contractor had breached his contract with the Government (see *Martin* v. *National Surety*, 300 U.S. 588, discussed at p. 14 hereof) and had thus cut off his rights to any further payment. See *Fidelity & Deposit Co.* v. *N.Y. Housing Authority*, 241 F. 2d 142 (1957); *U.S. Fidelity & Guaranty Co.* v. *Triborough Bridge Authority*, 297 N.Y. 31, 37 (1947); cf. *U.S.* v. *Bess*, 357 U.S. 51, 55; *U.S.* v. *Durham Lumber Co.*, 363 U.S. 522.

Conclusion

It is respectfully urged that the determination of the Court of Appeals in the instant case was completely correct and that the surety, by paying all labor and material claims, became entitled both as a matter of law and equity to reimbursement from the contract balances, and that these rights are superior to any claim to a windfall which the trustee, representing the general creditors of the bankrupt, might have.

As a result of the aforegoing it is respectfully submitted that the determination of the Court of Appeals herein should be affirmed and the fund ordered turned over to respondent, Reliance Insurance Company.

Respectfully submitted,

David Morgulas,
Amicus Curiae, on Behalf of The Association of Casualty and Surety Companies.

Certificate of Counsel

I hereby certify that I have served a copy of the foregoing brief on Raymond T. Miles, Esq., 942 Ellicott Square, Buffalo 3, New York, petitioner's counsel of record, and John G. Street, Jr., amicus curiae, 625 Forth Worth National Bank Building, Fort Worth, Texas, by depositing a copy of the same in a United States mail box, postage prepaid, addressed to each of the above counsel, at the post office addresses set forth above, on October 5th, 1962.

David Morgulas,
Amicus Curiae, on Behalf of The Association of Casualty & Surety Companies.

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE EDWARD M. MURPHY IN SUPPORT OF PETITIONER

EDWARD M. MURPHY
Amicus Curiae
420 S E Jackson Street
Roseburg, Oregon

INDEX

TABLE OF CASES CITED

STATUTES

MISCELLANEOUS

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner,

vs.

RELIANCE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE EDWARD M. MURPHY IN SUPPORT OF PETITIONER

TO THE HONORABLE SUPREME COURT OF THE UNITED STATES:

THE INTEREST OF THE AMICUS CURIAE

Your amicus curiae is attorney for Paulus F. McKee, Trustee in Bankruptcy for Funderburk Construction Corporation, a road construction contractor. Funderburk Construction Corporation was adjudicated a bankrupt in Case No. B-47910 in the United States District Court for Oregon. At the time of the bankruptcy the bankrupt had

partially completed the construction of a United States' forest access road known as the "Yellowstone Creek Project". The Trustee employed a contractor to complete the contract at a cost of $38,971.35 and thereby became entitled to receive from the Government a total payment of $59,702.66 or a net benefit to the bankrupt estate of $20,731.31. Federal Insurance Company, a Miller Act surety, paid laborers and materialmen on the Yellowstone Creek Project a sum in excess of $31,000.00 and has asserted a claim before the Referee in Bankruptcy to all of the proceeds due the Trustee from the completion of this project. A hearing has been held on this claim but the Referee has withheld decision pending the outcome of this case.

There is also now pending in the Court of Claims an action entitled "Phoenix Insurance Company, a corporation, and Stoen-Anderson Contractors, Inc., Plaintiffs vs. The United States of America, Defendant, Paulus F. McKee, Third Party Defendant, Case No. 120-60". In this case the plaintiff was a Miller Act surety on a bond for the construction by Funderburk Construction Corporation of a United States Government road in the State of Washington. The surety paid to certain subcontractors the sum of $53,437.38 and is asserting a claim to the retainage of $50,632.39 now held by the United States Government. The contract was completed prior to bankruptcy. The taking of testimony in this case has not been completed. On October 8, 1962, this Court granted permission for the filing of this brief.

ARGUMENT

THE SURETY-RESPONDENT IS NOT ENTITLED TO AN "EQUITABLE PRIORITY" IN THE ASSETS OF THE BANKRUPT

We believe that the Court's attention in this case should be focused entirely on the Bankruptcy Act. The case merited certiorari because it involved an important issue under the Bankruptcy Act. In Phoenix Indemnity Company v. Earle, 218 F.2d 645 (C.C.A.9) the Court placed particular emphasis on the fact that the issue here presented must be considered within the framework of the Bankruptcy Act. The surety here is seeking a priority in the funds of the bankrupt and the narrow issue before the Court is whether he is entitled to such priority under the Bankruptcy Act. Judge Medina at page 658 stated the issue to be "whether laborers and materialmen have an equitable priority in the retained funds". It is to this issue of "equitable priority" under the Bankruptcy Act that we address this brief.

The theme of the Bankruptcy Act is "equality of distribution". Nathanson v. N.L.R.B., 344 U.S. 25,29, 73 S. Ct. 80 (1952); U.S. v. Embassy Restaurant, Inc., 359 U.S. 29,31, 79 S. Ct. 554 (1959). If a preference is to be given a creditor the purpose should be clear from the statute. Nathanson v. N.L.R.B., 344 U.S. 25,29, 73 S. Ct. 80 (1952).

We assume that the term "equitable priority"

presupposes a security interest cognizable in equity. Justice Holmes in Sexton v. Kessler & Co., 225 U.S. 90, 52 S. Ct. 657,659 (1912) considered equitable lien as synonomous with equitable priority.

In U.S. v. Munsey Trust Co., 332 U.S. 234,243, 67 S. Ct. 1599,1603 (1947) the Court rejected the surety's claim to a security interest stating:

> "In any event, we are not prepared to apply law relating to security to unappropriated sums which exist only as a claim".

And this language has been subsequently relied on in rejecting the claim of a surety to an "equitable priority"; Fidelity & Deposit Co. v. New York City Housing Authority, 140 Fed. Supp. 298; and considered the heart of the Munsey Case by a law review commentator; see 33 Cornell Law Quarterly, 443,445.

An equitable lien presupposes a res to which a lien could attach but here the withheld payments never existed as a separate fund but were at all times a part of the general assets of the United States against which a voucher might be drawn by the contractor.

McKey v. Paradise, 299 U.S. 117, 575 S. Ct. 124 (1936)

Dillon v. Barnard, 21 Wall 430 (1874)

Sexton v. Kessler & Co., 225 U.S. 90, 52 S. Ct. 657 (1912)

If there could be said to be a res there is no evidence of any act by the United States

Government setting the res beyond its control and charging it with the claims of laborers and materialmen. In McKey v. Paradise, 299 U.S. 117, 575 S. Ct. 124 (1936) an attempt was made by representatives of an employees' welfare association to establish on behalf of the employees an "equitable priority" for wage deductions made by a bankrupt employer. The Court denied that the employees had "equitable title" or lien upon any part of the employer's property, stating: (P. 122)

> "No fund was segregated or set up by special depositor in any manner. When the wages became due, there was no such fund but only the general assets of the employer and its obligation to pay a debt."

We believe none of the elements of any "equitable priority" or lien are present in this case. There was no agreement to create a lien; there was no res to which a lien could attach and finally there was no appropriation of the res for the benefit of the laborer and materialmen.

Of course the laborers and materialmen had reason to expect that the contract proceeds would be applied to the payment of their claims but as stated in Dillon v. Barnard, 21 Wall 430,440 (1874),

> "The case * * is * * one of simple disappointed expectations against which misfortune equity furnishes no relief."

Since the term "equitable lien" is an "elastic phrase" (Collier on Bankruptcy, 14th ed Sec.

60.37 p. 884) and "intensely undefined" (Brunsdon v. Allard, 2 El. & El. 19) the proper administration of the Bankruptcy Act requires that it be confined within traditional narrow limits otherwise the "theme" of the Bankruptcy Act "equality of distribution" will be frustrated.

CONCLUSION

It is respectfully submitted that this Court should reverse the decision of the Second Circuit in the United States District Court for the Western District of New York and affirm the decision of Referee in Bankruptcy James R. Privitera. This would preserve the symmetry of the Bankruptcy Act and it would afford equality of distribution to all of the creditors.

Respectfully submitted,

Edward M. Murphy

Edward M. Murphy
Amicus Curiae

I hereby certify that I have served a copy of the foregoing brief on Hon. Raymond T. Miles, 942 Ellicott Square Building, Buffalo 3, New York, Petitioner's counsel of record, and Hon. Mark N. Turner, 440 M & T Building, Main and Swan Streets, Buffalo 2, New York, Respondent's counsel of record, by depositing, on October 17, 1962, a copy of same in a United States mail box with airmail postage prepaid, addressed to each of the above-named counsel

of record at the post office address set forth above.

Edward M. Murphy
Amicus Curiae

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner,

vs.

RELIANCE INSURANCE COMPANY,
Respondent.

RESPONDENT'S REPLY BRIEF TO BRIEF OF *AMICUS CURIAE* EDWARD M. MURPHY

MARK N. TURNER,
Attorney for Respondent,
440 M & T Building,
Buffalo 2, New York.

BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

INDEX

TABLE OF CASES CITED.

STATUTE.

IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

RESPONDENT'S REPLY BRIEF TO BRIEF OF *AMICUS CURIAE* EDWARD M. MURPHY

Introductory Statement

This reply brief is submitted pursuant to leave granted by this Court upon the oral argument on October 9, 1962.

On October 8, 1962, this Court granted the application of Edward M. Murphy of Roseburg, Oregon to file a brief *amicus curiae* in support of the petitioner. Mr. Murphy's brief had not been filed or served at the time of the argument, and this Court granted leave to respondent to file a brief in reply to Mr. Murphy's brief. Mr. Murphy's brief was received by the undersigned on October 19, 1962.

Discussion

We have now read the *amicus curiae* brief submitted by Mr. Murphy.

The arguments advanced would seem to fall into two (2) categories:

1. The "equality of distribution" under the Bankruptcy Act.

2. The lack of a "res" or fund to which the rights of the respondent could attach.

"Equality of Distribution" of a bankrupt's estate does not apply to "Trust Assets" of which the bankrupt was not the beneficial owner.

In *City of Dallas v. Crippen*, 171 Fed. (2) 526 (C. A. 5, 1948) cert. denied 336 U. S. 937, rehearing denied 336 U. S. 955, the Fifth Circuit wrote at page 529:

> "If the bankrupt holds property in trust for another, the trustee in bankruptcy takes title to such property charged with the trust. So long as the property can be identified according to sound trust doctrines of tracing and identification, it will be treated in bankruptcy as property to which creditors of the bankrupt have no claim, and will be paid over as a whole before disbursements are made to lienholders or unsecured creditors. Matters of this kind have no relation to priorities under Sec. 64, sub. a, 11 U. S. C. A. 104, sub. a."

To the same effect are:

Philadelphia National Bank v. McKinlay, 72 Fed. (2) 89, 91 (C. A. D. C. 1934), cert. denied 293 U. S. 583;

Martin v. National Surety Co., 300 U. S. 588, 593-594 (1937);

Massachusetts Bonding and Insurance Company v. State of New York, 259 Fed. (2) 33, at pages 36-38 (C. A. 2, 1958);

In Re Empire Granite Co. Inc., 42 Fed. Supp. 450, 453-454 (D. C. Georgia 1942);

In Re Franklin Savings & Loan Co., 34 Fed. Supp. 661, 664 (D. C. Tenn. 1940);

Whiting v. Hudson Trust Co., 234 N. Y. 394 (1923).

Counsel, on page 4 of the Murphy *amicus* brief, cites *Fidelity and Deposit Company of Maryland v. New York City Housing Authority*, 140 Fed. Supp. 298 (D. C. N. Y. 1956), in support of his contentions. He apparently failed to note that on appeal this case was reversed in 241 Fed. (2d) 142 (C. A. 2. 1957), and that the Court of Appeals Opinion was cited with approval by this Court in *United States v. Bess*, 357 U. S. 51 (1958) and in *United States v. Durham Lumber Co.*, 363 U. S. 522 (1960), as set forth on page 20 of our main brief.

It must be remembered that the entire fund in question, amounting to \$87,000, arose out of labor and materials ordered and placed by the bankrupt on its St. Lawrence Seaway prime contract prior to April 11, 1962 (Item 12 of Agreed Statement of Facts T. R. page 23). But it must also be remembered that the respondent, pursuant to its obligation under the payment bond, paid these labor and material bills aggregating \$349,000 (Item 9 of Agreed Statement of Facts T. R. page 22), *an amount four times as great as the \$87,000 fund in controversy. And, finally that there are no known unpaid job creditors on this job* (T. R. page 22).

In its amended proof of claim (T. R. pp. 41-44) respondent asserted its right to the fund "* * * by way of liens,

subrogation and assignment, * * *" (T. R. page 43) to the entire balance of moneys payable under the bankrupt's prime contract on the St. Lawrence Seaway job.

Here is a fund to which the contractor, here represented by the petitioner, its trustee in bankruptcy, contributed nothing from the general assets of the bankrupt's estate.

We respectfully suggest that the "equality of distribution" rule of the Bankruptcy Act does not *require* the fund to be distributed to general creditors who contributed nothing to the creation of the fund. Indeed, in simple fairness, equity and justice the fund should be awarded to the respondent.

The case of *Sexton v. Kessler & Co.*, 225 U. S. 90 (1912), cited on page 4 of the Murphy *amicus* brief, supports, rather than detracts from, the position of the petitioner.

The $87,000 fund is the "Res" or fund to which the Respondent's rights attached prior to bankruptcy.

We respectfully urge that consideration of the following facts clearly indicate the known presence of a specific "res" long prior to bankruptcy.

1. The execution of the payment bond in which the Contractor, here represented by the Petitioner, its Trustee in Bankruptcy, was principal and the Respondent was Surety, on April 11, 1955 (T. R. pp. 17-18).

2. That prior to the termination of the bankrupt's contract on April 11, 1956 the bankrupt had furnished labor and materials to the extent of $127,000 (but failed to pay for them), from which all parties agreed $40,000 should be deducted, leaving the $87,000 fund here in question (Items 14-16 of Agreed Statement of Fact T. R. pp. 23-24).

3. That during the Spring and Summer of 1956, the Surety, pursuant to its obligations under the payment bond, paid these unpaid job creditors $326,248.42; and, in addition, paid other job creditors additional sums, bringing the Surety's total claim payments up to $349,172.81; that as a result of these payments there then remained "no known unpaid laborers or materialmen" on the bankrupt's prime contract (Items 8-9 of Agreed Statement of Facts T. R. pp. 21-22).

4. That as a result of the foregoing, the $87,000 fund came into the hands of the Petitioner as a clearly identified fund or "res" (Item 16 of Agreed Statement of Facts T. R. p. 24).

Granting for the sake of the argument that, "whether enough has been done to give a right of any kind in certain property is a question of more or less" (*Sexton v. Kessler & Co.*, 225 U. S. 90 (1912)), we respectfully urge that under the circumstances here present there was a clearly identified "res", *viz.*, the $87,000 now in the hands of the Petitioner, which is the subject of this appeal.

We have already commented upon the *Sexton* case (225 U. S. 90), cited on page 4 of the Murphy *Amicus* brief. With respect to *McKey v. Paradise*, 299 U. S. 119, and *Dillon v. Barnard*, 21 Wall. 430, we suggest they are not in point here.

In the *Dillon* case (21 Wall. 430) it would seem that the basic question was whether a contractor who furnished labor and material to the owner of real property; with knowledge of a pre-existing mortgage on the property, could assert a lien or claim on the real property ahead of the prior mortgage. The answer of this Court quite properly was that the mortgage lien was superior.

On page 5, the Murphy *amicus* brief quotes from the *Dillon* case (21 Wall. 430, 440) the phrase "disappointed expectations against which misfortune equity furnishes no relief." The *Dillon* case was decided in 1874 and in a somewhat different setting.

We respectfully suggest that, in situations similar to those in the case at bar, the Courts, when the "chips are down", so to speak, have seen to it, with considerable uniformity, that the claims of job laborers and materialmen have been paid to the full extent of any and all available job contract moneys to the exclusion of other general creditors. For the most part their "expectations" were not "disappointed". In the following cases their "expectations" were realized to the fullest extent possible:

> *Belknap Hardware Co. v. Ohio River Co.*, 271 Fed. 144 (C. A. 6, 1921);
>
> *Philadelphia National Bank v. McKinlay*, 72 Fed. (2d) 89 (C. A. D. C. 1934), cert. denied 293 U. S. 583, 55 S. Ct. 96;
>
> *American Surety Company of New York v. Westinghouse Electric Mfg. Co.*, 296 U. S. 133, 56 S. Ct. 9 (1935);
>
> *Martin v. National Surety Co.*, 300 U. S. 588, 57 S. Ct. 531 (1937);
>
> *American Surety Company of New York v. Sampsell*, 327 U. S. 269, 66 S. Ct. 571 (1946).

In the *McKey* case (299 U. S. 119) the question was whether an employer who had agreed to set aside, *out of admitted general assets then in his possession*, a special fund for the benefit of his employees, but who failed to do so before bankruptcy, had so far segregated or dedicated any specific fund or "res" so as to create a trust or "res" for the benefit of the employees which was bind-

ing on the employer's trustee in bankruptcy. This Court properly held there had not been a sufficient identification or segregation to permit the carrying out of the employer's plan.

In the case at bar the \$87,000 fund, *long before it reached the hands of the trustee*, the petitioner herein, was clearly and specifically known and identified.

Conclusion

We respectfully submit:

1. We do not reach the question of the "equality of distribution" rule urged by the Murphy *Amicus* brief, inasmuch as the \$87,000 fund came into the hands of the Petitioner, the Contractor's Trustee in Bankruptcy, charged with the known paramount equity in favor of the Respondent.

2. The "res" is the \$87,000 fund, clearly known and identified long before bankruptcy.

3. The determination of the Court of Appeals should be affirmed, and the fund ordered turned over to the Respondent.

Respectfully submitted,

MARK N. TURNER,
Attorney for Respondent.
Office & P. O. Address,
440 M & T Building,
Buffalo 2, New York.

I Hereby Certify that I have served a copy of the foregoing brief on Raymond T. Miles, Esq., 942 Ellicott Square, Buffalo 3, New York, Petitioner's counsel of record, on John G. Street, Jr., *amicus curiae*, 625 Fort Worth National Bank Building, Fort Worth, Texas, upon David Morgulas, *amicus curiae*, 521 Fifth Avenue, New York City, New York, and upon Edward M. Murphy, *amicus curiae*, 420 S. E. Jackson Street, Roseburg, Oregon, by depositing a copy of the same in a United States mail box, postage prepaid, addressed to each of the above counsel, at the post-office addresses set forth above, on October ____, 1962.

MARK N. TURNER,
Counsel for Respondent.